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SCOTUS Decision Endorses Pomerantz Evidence Standard

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Pomerantz Partner Emma Gilmore led a team of Pomerantz attorneys and twenty-seven of the foremost evidence scholars to submit an amicus brief to the Supreme Court of the United States in *Goldman Sachs Group, Inc. et al v. Arkansas Teachers Retirement System, et al.* (No. 20-222). Pomerantz's brief was the sole amicus brief devoted to one of only two issues before the Court: whether the defendants in securities fraud class actions bear the burden of *persuasion* when seeking to rebut the presumption of reliance originated by the Court in its landmark decision in *Basic, Inc. v. Levinson*, or whether the defendants bear only the lower burden of *production*, as Goldman Sachs argued. On June 21, 2021, the Supreme Court held, in a 6-3 decision, that the defendants bear the ultimate burden of persuasion in rebutting the Basic presumption. In so holding, the Court adopted the arguments asserted by Pomerantz and the law professors in their amicus brief.

To state a claim for securities fraud, a plaintiff must establish that she relied on a misrepresentation or omission when she bought or sold securities. The misrepresentation or omission artificially inflates a security's price until the statement's false or misleading nature is disclosed — at which point, the stock price falls, harming investors. If each plaintiff bringing securities fraud claims had to prove individual reliance on a specific misrepresentation, however, it would be virtually impossible to bring securities fraud claims as class actions, because each plaintiff would need to individually demonstrate how she relied on the misrepresentation when she bought or sold securities. In *Basic*, however, the Supreme Court held that securities fraud plaintiffs can invoke a presumption that they relied on a misrepresentation in buying or selling securities because, in an efficient market, the price of a security reflects all the company's material public statements, including false or misleading statements. The "fraud on the market" presumption of reliance the Supreme Court established in *Basic* thus obviated the need for each member of a class to show reliance on a case-by-case basis, enabling securities fraud lawsuits to proceed as class actions.

To invoke the *Basic* presumption, a plaintiff must prove that (1) an alleged misrepresentation was publicly known; (2) it was material (i.e., significant to a "reasonable investor"); (3) the security traded in an efficient market; and (4) the plaintiff traded the security between the time the misrepresentation was made and when the truth was revealed. Once a plaintiff has established these four elements, all similarly situated class members are presumed to have relied upon the misrepresentation in deciding whether to buy or sell the security.

A defendant can rebut this presumption, however, by producing evidence reflecting that the alleged misrepresentation did not affect the price of the security.

Pomerantz's amicus brief argued that defendants bore the heavier burden of persuasion:

> *Basic* made clear that to overcome the presumption of reliance, defendants must actually "sever the link" between the alleged misrepresentation and the price of the security. 485 U.S. at 248. *Halliburton II* reaffirmed this holding and suggested that "sever[ing] the link" would require defendants to adduce "more salient" evidence than the plaintiffs. 573 U.S. at 282. Thus, the language of *Basic* and *Halliburton II*, together with their focus on advancing Congress's intent, show that the Court imposed on defendants the burden of persuasion, and not just a burden of production, to rebut the presumption.

Emma Gilmore, Partner

Goldman argued that Federal Rule of Evidence 301 places the burden of persuasion on plaintiffs. Rule 301 states that while "the party against whom a presumption is directed has the burden of producing evidence to rebut the presumption," this "does not shift the burden of persuasion, which remains on the party who had it originally." Therefore, Goldman argued, defendants need only produce some evidence of no price impact, leaving plaintiffs with the ultimate burden of persuasion.

Pomerantz's amicus brief, however, argued that (i) courts have the ability to reassign the burden of persuasion to any party regardless of Rule 301, and (ii) the Supreme Court's prior decisions had assigned to defendants the burden of persuasion with regard to the presumption of reliance. Pomerantz's amicus brief argued that:

> Courts and commentators alike have understood that when necessary to satisfy the demands of the substantive law being applied—including "statutory policy"—courts may diverge from Rule 301's default

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> rule and allocate the burden of persuasion to the opposing party. Indeed, this Court has declared that Rule 301 "in no way restricts the authority of a court or an agency to change the customary burdens of persuasion in a manner that otherwise would be permissible" (citations omitted).

The brief explained that the language in prior Supreme Court decisions reflected the Court's intent to assign the burden of persuasion to defendants:

> This Court's decisions in *Basic* and *Halliburton II* [*Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258 (2014)*] reflect precisely this sort of consideration of substantive law of a statute—here section 10(b) of the Securities Act—in both creating the Basic presumption and assigning the burden of persuasion to defendants to rebut it. Thus, the statute and its substantive law apply, not the generally applicable Rule 301.

The Supreme Court adopted Pomerantz's and the evidence scholars' arguments. The Court began its analysis by observing that:

> We have held that Rule 301 "in no way restricts the authority of a court … to change the customary burdens of persuasion" pursuant to a federal statute. *NLRB v. Transportation Management Corp.*, 462 U. S. 393, 404, n. 7 (1983). And we have at times exercised that authority to reassign the burden of persuasion to the defendant upon a prima facie showing by the plaintiff. *See, e.g., Teamsters v. United States*, 431 U. S. 324, 359, and n. 45 (1977); *Franks v. Bowman Transp. Co.*, 424 U. S. 747, 772– 773 (1976).

The Court then held that, as Pomerantz and the law professors argued, *Basic* and *Halliburton II* did allocate the burden of persuasion to defendants:

> *Basic* held that defendants may rebut the presumption of reliance if they "*show* that the misrepresentation *in fact* did not lead to a distortion of price." 485 U. S., at 248 (emphasis added). To do so, *Basic* said, defendants may make "[a]ny *showing* that *severs the link* between the alleged misrepresentation and … the price received (or paid) by the plaintiff." *Ibid*. (emphasis added). Similarly, *Halliburton II* held that defendants may rebut the *Basic* presumption at class certification "by *showing* … that the particular misrepresentation at issue did not affect the stock's market price." 573 U. S., at 279 (emphasis added).
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> Thus, the best reading of our precedents … is that the defendant bears the burden of persuasion to prove a lack of price impact.

Notably, in so holding, the Supreme Court cited with approval the Second Circuit's ruling in *Waggoner v. Barclays PLC*, 875 F. 3d 79, 99–104 (2d Cir. 2017) that the phrase '[a]ny showing that severs the link' aligns more logically with imposing a burden of persuasion rather than a burden of production." Pomerantz successfully prosecuted the claims in *Barclays*, spearheading a similar amicus brief on behalf of numerous leading evidence scholars.

Pomerantz's and the amicus professors' win in the Supreme Court ensures that aggrieved investors can continue to aggregate their claims as a class against companies that defraud them.

Emma Gilmore stated, "The Supreme Court's decision is a significant victory for plaintiffs and against defendants seeking to demolish the presumption of reliance that has allowed aggrieved investors to pursue securities act violations as a class. Twenty-seven of the foremost evidence scholars in the United States backed our position; not a single one backed the defendants'. This important win paves the ground for more victories on behalf of defrauded investors." ■

Plaintiff Takeaways from High Court's Goldman Ruling

On June 22, 2021, in *Goldman Sachs Group Inc. v. Arkansas Teacher Retirement System*, the United States Supreme Court rendered a decision critical to the future of federal securities fraud class actions. In a July 2 article in *Law360*, Marc I. Gross and Jeremy A. Lieberman analyzed what that means for the plaintiffs' bar. The following is an abbreviated recap of their analysis.

The Court held that in determining whether allegedly misleading statements impacted stock prices, (1) a court should consider the "generic nature" of the statements by way of expert opinion, other empirical evidence and "common sense"; and (2) defendants bear the burden of persuasion to demonstrate that the statements had no impact on market prices.

While defendants have framed the holding on the first point as a big win for their bar, Marc and Jeremy beg to differ. [Eds: For a discussion of the second point, see this issue's article on Pomerantz's amicus brief.]

The generic nature of statements has often been considered at the motion-to-dismiss and class stages. What the Supreme Court made clear, though, was that the generic nature of statements did not render them per se unworthy of class certification, but rather, it is one factor to be weighed along with empirical evidence and expert testimony regarding actual price impact.

A central element of securities fraud claims is proof that investors relied upon allegedly misleading statements when purchasing shares. Following the 1966 adoption of Rule 23 in the Federal Rules of Civil Procedure, courts wrestled with how to prove reliance on a basis common to all class members. If each investor had to prove they actually read the misstatement, individual issues of proof would predominate, rendering securities fraud class actions unmanageable.

The concept that defendants' misrepresentations create a fraud on the market was first developed by Abe Pomerantz,

pioneer of shareholder rights litigation and founder of Pomerantz LLP, in the 1970 case, *Herbst v. Able*. Thereafter, courts recognized that if companies inflated their reported earnings, the stock market price of their securities would likely be inflated as well, thereby causing all investors to be defrauded.

In 1988, the Supreme Court embraced this concept in *Basic Inc. v. Levinson*, formalizing a "presumption" of reliance where stocks were traded in "efficient" markets, i.e., markets that rapidly priced all public information (including misinformation).

Basic also held that the presumption could be rebutted if individual investors relied on nonpublic information. The Supreme Court revisited this presumption in 2014's *Halliburton Co. v. Erica P. John Fund Inc.* decision. While reaffirming the presumption's viability, the court expanded the grounds for its rebuttal. Defendants could also cite evidence demonstrating that the misleading statements had no impact on the stock price.

The dispute in *Goldman* arose over market impact, or lack thereof, of statements by Goldman representing that the investment bank had "extensive procedures and controls that are designed to identify and address conflicts of interest" and that "integrity and honesty are at the heart of our business."

The plaintiffs argued that these statements were materially misleading, citing revelations that Goldman had assembled a portfolio of mortgage-backed securities for the benefit of a short-seller, without disclosing this to Goldman clients to whom the bank sold the portfolios and who lost billions of dollars in the 2008 Great Recession. The SEC fined Goldman $550 million for its misconduct.

Goldman moved to dismiss the lawsuit, arguing that its statements were too generic and aspirational to warrant reliance. The U.S. District Court for the Southern District of New York denied the motion in 2012.

At the class motion stage, Goldman again argued that the generic nature of the statements had no market price impact, focusing on the absence of any price change when the statements were issued, nor when journalists questioned the company's actual client conflict practices.

The plaintiff countered that Goldman had consistently denied any wrongdoing and that its misleading statements effectively maintained the price of Goldman shares until the truth was revealed, causing analysts to question the investment bank's reputation and the stock price to crater.

The district court twice found that defendants failed to show that the Goldman stock price was not impacted by the misstatements. The U.S. Court of Appeals for the Second Circuit agreed twice. However, in the second decision, U.S. Circuit Judge Richard Sullivan dissented, asserting:

> The obvious explanation for why the share price didn't move after 36 separate news stories on the subject of Goldman's conflicts is that no reasonable investor would have attached any significance to the generic statements on which Plaintiffs' claims are based.

The majority retorted:

> What the dissent really wants to do is to revisit the question of whether the statements are too general as a matter of law to be deemed material.

Goldman sought certiorari based on Judge Sullivan's dissent, though its opening brief did not embrace his per se analysis, pivoting instead to the argument that generic nature is just one factor considered in determining price impact. Plaintiffs thus had no reason to disagree.

In her opinion on this issue, in which all the justices joined, Justice Barrett held that, in determining the price impact of generic statements, courts "should be open to all probative evidence on that question — qualitative as well as quantitative — aided by a good dose of common sense," regardless of whether the issue overlapped with questions of materiality.

Critical to going forward is Justice Barrett's observation that there may be a "mismatch between the contents of the misrepresentation and the corrective disclosure." The Court suggested that this could occur where the earlier misstatement was very broad (e.g., "We have faith in our business model"), while the later corrective statement is specific (e.g., "Our fourth quarter earnings did not meet expectations").

Frankly, both statements are generic and arguably a mismatch, since nothing in the prior statement targeted specific earnings growth. In contrast, in *Goldman*, the company stated it had strong procedures to prevent conflict of interests, yet those procedures had been flaunted.

Undoubtedly, class certification motions will now shift to battles over the degree to which misstatements and corrective disclosures match.

Courts have recognized that corrective disclosure need not be the "mirror image" of the alleged misrepresentation. Plaintiffs will likely argue that a sufficient degree of overlap in the before and after statements, coupled with empirical evidence (such as analysts' interpretation of the corrective statements), should suffice to support certification. This will leave for later determination the degree to which the post-corrective stock price decline can be linked to the prior misstatement — an issue that experts often sort out through confounded event analysis.

Also relevant to the evaluation of price impact of such generic statements is their context; e.g., whether the generic statement was intended to distinguish the company from its own prior misconduct or that of its peers.

Plaintiffs will also likely argue that in assessing price impact, courts should consider not just what defendants said, but what they omitted. It is well settled, as expressed by the Second Circuit in 2016's *In re: Vivendi SA Securities Litigation*, that "once a company speaks on an issue or topic, there is a duty to tell the whole truth, even when there is no existing independent duty to disclose information" on the matter.

In other words, having opted to burnish its corporate image

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Jeremy A. Lieberman, Managing Partner

Marc I. Gross, Senior Counsel

Q&A

Dolgora Dorzhieva

The *Monitor* recently spoke with Dolgora Dorzhieva, an associate in the firm's securities litigation practice group.

***Monitor*: Could you tell us about your early years?**

Dolgora Dorzhieva: I grew up in the city of Ulan-Ude, the capital of Buryatia, an ethnic republic in Eastern Siberia, Russia, near the border of Mongolia. Ulan-Ude is adjacent to Lake Baikal, the largest (by volume) and deepest lake in the world. I spent summers on my grandmother's farm, in the remote village of Tashir. It had dirt roads, no internet, and often no electricity. At the age of 11, I herded sheep with German shepherd dogs, protecting the flock from wolves. I feel fortunate to have experienced what is now a disappearing lifestyle. My grandmother Vera taught school in the village. She and her sisters were orphaned during World War II. Vera managed to put herself and her two little sisters through school, starting when she was 11 and they were 5 and just under one year old. My *Babula* Vera was my academic inspiration and one of the smartest people I've ever met.

M: When did you decide to be a lawyer?

DD: I have wanted to be a lawyer since I was a little girl. In Russia, you cannot apply to law school by emailing documents remotely. You have to actually travel to each school, be interviewed, and take their exams. After graduating from high school with the gold medal (as class valedictorian), I convinced my mother to buy me a plane ticket to Moscow. I'd never been there, but somehow I got her to agree. All the law schools wanted money "under the table," which I didn't have, so I wasn't accepted at any. I didn't want to disappoint my family by coming back empty-handed. Having written articles for local newspapers, I opted for journalism.

M: Did you get a degree in journalism?

DD: No, following my fourth year (five being required for a degree), I came to New York as an exchange student on a J1 visa. Finding the freedom and opportunities in America irresistible, I stayed and eventually applied for political asylum. My four years of journalism have helped me as a lawyer. This job is as much about telling a story as journalism is.

M: What path led you to a career in securities fraud litigation?

DD: I took a "Complex Civil Litigation" class with Elizabeth Cabraser at Berkeley and she inspired me to pursue a career challenging the imbalance of power between average people, like you and me, and corporations.

M: What is the most intriguing issue that you have litigated so far?

DD: We have a case pending against Deutsche Bank, alleging that it violated its own Know Your Customer procedures when it onboarded and serviced Jeffrey Epstein. Unconscionably, Deutsche Bank knew that Epstein was using his accounts to further his crimes but failed to close them because he was so profitable for the bank.

M: What aspects of your work do you find most rewarding?

DD: As a plaintiffs' securities litigator, it is rewarding to speak truth to power. I enjoy working with investigators and hearing the stories of confidential witnesses, which can be fascinating. The most rewarding aspect is the ability to solve someone's problem and deliver a tangible result. I defeated a professional objector in a consumer fraud case and secured a favorable settlement in an individual employment case early in my career. I still have the text messages from the client in the employment case, who thanked me profusely. Those text messages remind me of why I became a lawyer. I also find it rewarding to pay it forward: I advise students from Berkeley on judicial clerkships.

M: A generation ago, women in law faced many challenges specific to their gender. As a member of a younger generation, how far do you think we have come, and how far do we still have to go?

DD: At Berkeley, I was fortunate to meet several women trailblazers who paved the way for my generation: Professor Eleanor Swift, Justice Maria P. Rivera of California's Court of Appeal, Elizabeth Cabraser, and Professor Herma Hill Kay. In comparison with their struggles —and, thanks to them—young female lawyers now have a far easier path. We still have a long way to go, but I want to applaud my generation for being more assertive and open-minded about the role of women in law.

M: Have you faced special challenges in the United States as an Asian immigrant?

DD: Fortunately, I have not personally experienced direct racism here. In contrast, I was at university in Moscow during the war with Chechnya. There were skinhead gangs harassing and assaulting people like myself, on the streets and in the subway, who did not look Slavic like them. I had some frightening experiences. When I arrived in New York, it was a breath of fresh air. I love America and everything this country has bestowed on me. I came here alone, 21 years old, with limited English and a thousand dollars in my pocket. Hard work and perseverance helped me get this far; I don't think that any other country in the world would allow an immigrant to do that. Two of my most exciting memories: the day I was accepted to Berkeley Law and the day I took the oath of allegiance as an American citizen.

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M: What is your perspective on the American legal system?

DD: I think it's one of the finest and certainly most sophisticated legal systems in the world. However, it has serious flaws, especially within the criminal justice system. Of course, the Russian legal system is notoriously corrupt. Not that the American legal system is perfect; however, many corrupt individuals do get caught and punished. The jury institution within the American legal system is the backbone of our democracy and our collective power as the People. American law is constantly evolving, allowing for a lifetime of learning.

M: What advice would you give to young women considering a career in law?

DD: The same advice I would give to young men: if you are not willing to work hard and make sacrifices in your personal life, this profession might not be for you. You should cultivate your organizational skills and attention to detail. To quote Hillary Clinton: "RTDD!" (Read the Damn Documents!) In other words, there are no shortcuts. Always remember: "You don't know what you don't know," and that preparation is crucial.

M: What do you hope to achieve over the next decades?

DD: I want to learn the ins and outs of trials and become an excellent trial attorney. One day, I hope to look back on an exciting career in which I have helped others.

M: Outside of the office, what are your interests or hobbies?

DD: I love nature and spend what time I can hiking in New Jersey or relaxing on the beach, at Sandy Hook. I haven't gone to the movies since the pandemic; I miss that. A professor at City College of New York showed us "*12 Angry Men*;" that led me to Turner Classic Movies. I only recently saw "*The Wizard of Oz*;" I loved it! Music has been a huge passion since I was a kid, from the Beatles to Billie Eilish, and I really enjoy the great American art form: jazz. Miles Davis's "*Sketches of Spain*" was instrumental in me passing the bar.

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by professing its integrity and internal control procedures to prevent conflicts, Goldman was arguably duty bound to disclose all related material information lest investors be misled by the omission thereof, including the risk that it had departed from that professed policy. Had Goldman acknowledged such departures, its stock price would likely have declined much earlier than it did.

Finally, courts will need to wrestle with just what is generic and what is meaningful in the minds of investors. This determination has often rested on the courts' intuitive conception of a reasonable investor. Empirical studies have demonstrated that investors place considerable stock in the perception of management's integrity and reliability, and that a substantial portion of a company's market value is a function of that reputation, which such generic statements serve to burnish.

If such generic statements were intended to reassure investors of the company's reliability and integrity, plaintiffs may well argue that such statements maintained the premium that investors were willing to pay for a company's strong reputation. This arguably should bear upon class certification of generic statements, as well as their actionability at the pleading stage. ■

You may read Marc and Jeremy's entire article at:
https://www.law360.com/articles/1399412/plaintiff-takeaways-from-high-court-s-goldman-ruling?copied=1

Court Rebuffs Activist on Forced Arbitration Provisions

By Michael Grunfeld

Johnson & Johnson ("J&J") has been involved since March 2019 in litigation against a small shareholder represented by Professor Hal S. Scott, the Director of the Program on International Financial Systems at Harvard Law School. Professor Scott is seeking to have J&J shareholders vote on a proxy proposal instituting a corporate bylaw that would require all securities fraud claims against the company to be pursued through mandatory arbitration, and that would waive shareholders' rights to bring securities class actions. The litigation arose after J&J rejected the proposal because it would be contrary to New Jersey law. Professor Scott then decided to file an action in Federal District Court in New Jersey contesting J&J's rejection, in an action called *The Doris Behr 2012 Irrevocable Trust v. Johnson & Johnson*. Pomerantz has been involved in the litigation on behalf of the Colorado Public Employees' Retirement Association ("Colorado PERA"), as an intervenor seeking to ensure that investors' rights are protected.

On June 30, 2021, Judge Michael A. Shipp of the United States District Court for the District of New Jersey handed down an important victory for shareholders when it granted J&J's and the Intervenors' Motion to Dismiss. This decision was the result of several years of legal maneuvering. First, on April 8, 2019, the court denied Professor Scott's motion for an order compelling J&J to include the proposal in its proxy for its 2019 shareholder meeting because he acted too late for that year. Then, after Professor Scott filed an amended complaint on May 21, 2020, J&J informed him, apparently to avoid further litigation, that if he were to properly submit his shareholder proposal for inclusion in the company's 2021 proxy materials, the company would include it and allow its shareholders to vote on the proposal at J&J's 2021 annual meeting.

Michael Grunfeld, Partner

Rather than take J&J up on its offer, which would have allowed Professor Scott to achieve his purported goal of having J&J's shareholders decide on whether they actually ***want*** his proposed forced arbitration provision, Professor Scott continued with his litigation. As J&J explained in its motion to dismiss:

> Given the Company's agreement to include the Proposal in the 2021 Proxy Materials, there is no reason to continue to litigate this action. The only explanation for Plaintiff's refusal to voluntarily dismiss this action is Plaintiff's trustee's academic interest in obtaining a judicial decision on the validity of mandatory arbitration bylaws—a crusade that Plaintiff's trustee has pursued for years. But it is well-established that this Court cannot issue an academic decision that would amount to no more than a hypothetical advisory opinion.

The Court agreed. Judge Shipp explained in his decision granting the motion to dismiss that plaintiffs' request for declaratory relief as to the past proxy materials is moot because the time for that proposal has passed. The Court also ruled that plaintiffs' request for declaratory relief as to potential future proxy proposals is not ripe because it is "too hypothetical at this juncture and contingent on future events." This is because the plaintiffs "fail[ed] to identify any specific shareholder meeting for which they 'wish' to resubmit the proposal, let alone the next shareholder meeting in 2022," as well as the fact that J&J informed plaintiffs that the company "will no longer exclude the Trust's proposal from its annual proxy materials." The Court therefore also determined that it could not issue an opinion as to whether the Proxy Proposal is permitted under New Jersey law, because such a ruling "would amount to an advisory opinion." Federal courts may not issue advisory opinions because they "may not decide questions that cannot affect the rights of litigations in the case before them or give opinions advising what the law would be upon a hypothetical state of facts."

The court allowed plaintiffs a final opportunity to amend their complaint. Plaintiffs filed an amended complaint on

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July 13, 2021, stating that they plan to resubmit their shareholder proposal for consideration at Johnson & Johnson's 2022 annual shareholder meeting, and seek a declaratory judgment as to the legality of the proposal. The litigation will therefore continue for the time being and Pomerantz will continue to ensure that the interests of shareholders are represented therein.

This litigation raises the critical right of shareholders to bring securities class actions in court rather than being forced into arbitration proceedings that would preclude shareholders' ability to band together as a class. These rights are essential for shareholders to be able to seek recovery, and hold companies accountable, for securities fraud for several important reasons. One is that it would otherwise be prohibitively costly and difficult for most investors to bring claims on an individual basis. Moreover, in addition to allowing individual investors to seek redress, the availability of securities class actions provides the market and investors with an important prophylactic mechanism that deters companies and their executives from committing securities fraud. The transparency and accountability of the public court system, as opposed to the private and closed nature of arbitration, is essential for these protections to function properly.

Historically, the Securities and Exchange Commission ("SEC") has opposed proposals to mandate arbitration of securities claims. The SEC even issued a No Action letter in this matter, telling J&J that it would not object to the company's exclusion of Professor Scott's Proposal. (See our prior discussion of this action: https://pomlaw.com/monitor-issues/can-shareholders-propose-bylaws-requiring-mandatory-arbitration-of-securities-fraud-claims). This has even been the rare issue about which investors and company management have tended to agree. In addition to J&J initially rejecting the mandatory arbitration proposal here, the board of directors of Intuit, another prominent public company, recently recommended against a similar proposal by Professor Scott, because it was "not in the best interest of Intuit or its shareholders." Over 97.6% of Intuit's shareholders agreed when they rejected the proposal. (See https://pomlaw.com/monitor-issues/intuit-shareholders-and-directors-reject-forced-arbitration-proposalintuit-shareholders-and-directors-reject-forced-arbitration-proposal).

Pomerantz has actively defended shareholders against forced arbitration beyond the courtroom as well. Several years ago, when the SEC hinted that it might consider allowing companies to include mandatory arbitration clauses in their bylaws, Pomerantz organized a coalition of large institutional investors from around the globe to meet with then-SEC Chairman Jay Clayton and later, with both Republican and Democratic Senate staffers. On November 13, 2018 – two weeks after the SEC meetings – ten Republican State Treasurers, in a letter co-authored by the State Financial Officers Foundation, urged the SEC to maintain their existing stance against forced arbitration. (See https://pomlaw.com/monitor-issues/protecting-shareholder-rights-forcing-away-forced-arbitration-clauses).

Shareholders must continue to be vigilant in protecting their right to bring securities class actions. Professor Scott is continuing to pursue his case against J&J, others seeking to impose mandatory arbitration on shareholders might continue to take up the matter in other forums, and the issue has not been addressed by the U.S. Supreme Court. Even so, the dismissal of Professor Scott's earlier complaint against J&J is a great result for shareholders, especially given the overwhelming rejection by Intuit's shareholders of Professor Scott's mandatory arbitration proposal. J&J's calling Professor Scott out on his true intention of pursuing his longstanding "academic interest" in seeking a favorable court ruling, rather than focusing on whether shareholders actually want his proposal, explains why there was no need for the Court to rule here on a purely hypothetical question.

85 YEARS

The Case That Quashed Fee-Shifting Bylaws

Gustavo F. Bruckner, Partner

The *Monitor* continues its look back at the Firm's 85-year history.

On May 30, 2014, First Aviation Services, Inc. completed what was virtually a hostile takeover, executing a 10,000-to-1 reverse stock split that effectively took the company private by involuntarily cashing out every investor holding less than 10,000 shares. When the dust settled, Aaron Hollander, First Aviation's Chief Executive Officer and controlling shareholder, had effectively taken ownership of the company without needing to lay out any capital. Adding insult to injury, within four days of the stock split coup, First Aviation adopted a fee-shifting bylaw that required any stockholder who challenged the ouster of their investment to pay the company's legal fees unless they succeeded in obtaining "a judgment on the merits that substantially achieves … the full remedy sought." Unless any challenger prevailed on every issue that they argued, they would be forced to pay the uncapped legal fees incurred by the company.

Setting the stage for a showdown, the Delaware Supreme Court took on the issue of fee-shifting bylaws in a 2014 case named *ATP Tour, Inc. v. Deutscher Tennis Bund*. ATP, the operator of a professional men's tennis tour, had successfully defeated litigation by two member federations that arose from changes made to the format and scheduling of the tour, and sought to recover its legal fees per its fee-shifting bylaw. The Delaware Supreme Court ruled that "[u]nder Delaware law, a fee-shifting bylaw is not invalid per se, and the fact that it was adopted after entities became members will not affect its enforceability."

The same year, Pomerantz was approached by a client seeking to stop the forced liquidation of his investment in First Aviation. With a genuine interest in the company and its financial prospects, the investor had no interest in being forced to divest his shares, especially at a rate that was several dollars below what the stock had recently traded at. Although the class-wide damages were modest, Pomerantz considered the issue important, and took on the case on behalf of this client and approximately 200 other investors who were just two weeks away from being booted as shareholders.

After the complaint against First Aviation (*Strougo v. Hollander*) was filed, a series of 'after the fact' revelations raised the stakes of the case on several levels. First, the company revealed that it had received a large government contract — one that it knew about before the reverse stock split was announced but failed to disclose to the market — and one from which the now cashed-out investors would not realize any benefit. Second, First Aviation revealed the existence of the fee-shifting bylaw that placed the plaintiffs in substantial potential financial jeopardy. And, later in the litigation, as we will recount, a third revelation provided the key to victory.

While Pomerantz was uncovering the true depth of the deception surrounding the reverse stock split, the plaintiffs' bar at large took notice of this modest securities case. The potential recovery was just a few hundred thousand dollars, but an adverse ruling that saw such bylaws being sustained threatened the future viability of securities litigation as we know it. The adoption of fee-shifting bylaws would be the death knell for shareholder litigation, as no plaintiff would risk being on the hook for legal fees and expenses.

With those stakes in the balance, the attention on this case was intense. Pomerantz partners Gustavo Bruckner, Marc Gross and Jeremy Lieberman were deluged with missives from other plaintiffs' firms attempting to persuade them to either not litigate *Hollander*, or to allow larger firms to step in to find some solution … any solution … other than a judicial decision.

Under tremendous pressure not to risk an adverse ruling, Pomerantz saw an opening — ask the court to stay its ruling on the complaint itself but split out the issue of the bylaw first for a ruling on its validity. Recognizing the larger issue at hand, the Court agreed.

It was at this stage that Pomerantz made a shocking discovery — the yet-to-be seen bylaw had been adopted a mere four days after the stock split and applied retroactively to all shareholders, even those who were cashed out in the transaction.

This revelation drew the map for a pathway to victory without jeopardizing the foundation of securities litigation. Pomerantz asked the Court to further limit its ruling to one question — is a bylaw adopted after a former stockholder has already cashed out still binding on them? Clearly, bylaws are binding on all current shareholders at the time of adoption and those who buy stock afterwards. But, based on the principle of Delaware law that has positioned the stockholder-corporation relationship as akin to a contract, that 'contract' would end as soon as the stock is either sold or taken away — as in the situation of a cashed-out reverse stock split. It followed that a fee-shifting bylaw, adopted after the investor is no longer holding stock in the company, would not apply to them.

As a result, in March 2015, Chancellor Bouchard of the Delaware Court of Chancery ruled that "[A] stockholder whose equity interest in the corporation is eliminated in a cash-out transaction is, after the effective time of that transaction, no longer a party to [the] flexible [corporate] contract. Instead, a stockholder whose equity is eliminated is equivalent to a non-party to the corporate contract, meaning that former stockholder is not subject to, or bound by, any bylaw amendments adopted after one's interest in the corporation has been eliminated."

On the effect of fee-shifting bylaws, the Chancellor further wrote that "the Bylaw in this case would have the effect of immunizing the Reverse Stock Split from judicial review because, in my view, no rational stockholder—and no rational plaintiff's lawyer—would risk having to pay the Defendants' uncapped attorneys' fees to vindicate the rights of the Company's minority stockholders, even though the Reverse Stock Split appears to be precisely the type of transaction that should be subject to Delaware's most exacting standard of review to protect against fiduciary misconduct."

Simultaneously, as Pomerantz sought to sway the court, it also spearheaded efforts to find a legislative solution that would forestall any fallout in the event of an adverse decision in *Hollander*. The Firm campaigned to educate Delaware's governor, Supreme Court, and legislature in regard to the scope of the threat that fee-shifting bylaws posed to shareholder rights and the balance of the corporate ecosystem — an issue very germane in the state that is the home of the most newly formed corporations every year.

After discussions between prominent legal academics, members of Delaware's executive, judicial, and legislative branches, and the representatives of the plaintiffs' bar, examining the effect that fee-shifting bylaws would likely have on shareholders' rights and their ability to mount legal challenges to corporations in court, Delaware realized it needed to act. On June 11, 2015, the Delaware General Assembly passed Senate Bill 75, a statute which amended the Delaware General Corporation Law to effectively prohibit fee-shifting bylaws. Governor Jack Martell signed the bill into law on June 25, 2015.

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