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The *Vivendi* Ruling: Revisiting Three Key Issues (and Adding Two More)

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In the March 2010 issue of *Securities Litigation Report*, we reviewed the January 2010 jury verdict in *In re Vivendi Universal S.A. Securities Litigation* in the Southern District of New York, and identified three aspects of the verdict that stood out to us as interesting. The jury had found no liability with respect to Vivendi's former CEO Jean-Marie Messier and its former CFO Guillaume Hannezo, and that Vivendi Universal S.A. (Vivendi) had committed securities fraud under § 10(b) of the Securities Exchange Act of 1934.[1]

Immediately following the discharge of the jury, Vivendi orally renewed an earlier motion for judgment as a matter of law (JMOL) under Federal Rule of Civil Procedure 50(b). Vivendi also orally moved for a new trial under Rule 59. In briefing, Vivendi styled its motion as a motion for JMOL or, in the alternative, for a new trial. The plaintiffs moved for entry of judgment. Judge Richard J. Holwell issued a 121-page opinion on February 17, 2011, nearly a year after the motions were filed.[2] The opinion provides a detailed analysis of each argument presented by each party.

In this article we revisit the three *Vivendi*-verdict issues discussed in our March 2010 article and review Judge Holwell's approach to them. We also discuss two additional areas of interest addressed in Judge Holwell's opinion. Together, these five issues could very well form the core of any appeals.

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From the EDITORS

SEC Accountant Raises Frightening Specter of Litigation Contingency Disclosures

Companies may to have to start providing better disclosure of possible litigation contingencies, including in some cases, offering estimates of what the monetary damages could be, said Wayne Carnall, chief accountant for the Securities and Exchange Commission's Division of Corporation Finance, in a recent speech before a legal conference.

Warning lawyers in attendance that SEC Staff has seen "a lack of disclosure with respect to 'reasonably possible' losses," Carnall questioned whether companies were fully complying with Accounting Standards Codification Topic 450 (ASC 450), the provision of U.S. Generally Accepted Accounting Principles (GAAP) that addresses those contingencies.

So much for a speech by an accountant being boring.

Echoing Carnall's words with actions, the SEC Staff has begun more closely questioning, in recent comment letters, whether companies are adequately disclosing possible litigation contingencies they may become, or already are, involved with, and whether companies have provided proper estimates of potential monetary losses due to claims that could be decided against them. Under ASC 450, companies have to evaluate whether a loss from litigation is "probable," whether the amount of loss can be "reasonably estimated" and the range of those estimates, if they can be determined. In cases where a loss is "reasonably possible," companies should include "an estimate of the possible loss or range of loss or a statement that such an estimate cannot be made."

Corporate lawyers and defense counsel blanch at the prospect of disclosing to shareholders and the public—including future and current plaintiffs and their lawyers—how likely a company is to lose any potential litigation situation, and especially, how much those losses could cost the company. So much so, that in 1975, a so-called "treaty" was established between the American Bar Association and the American Institute of Certified Public Accountants.

The treaty guides discussions between auditors and corporate counsel regarding how to disclose litigation contingencies in a company's financial statements. In the treaty, corporate lawyers are urged not to disclose certain information, including estimates of potential losses from litigation, to outside auditors, unless the lawyers are certain of the estimate's accuracy. For the last 35 years, lawyers and auditors have used the treaty to navigate (some would say, evade) the sticky problem of litigation contingency disclosures.

However, as Carnall warned his audience, that treaty does not trump GAAP requirements and is no defense for nondisclosure of litigation contingencies or loss estimates.

Michael R. Young, of Willkie Farr & Gallagher, LLP (and a member of *SLR*'s Editorial Advisory Board) sounded the alarm on Carnall's comments. In a Client Memo, Young wrote that Carnall has "made clear that litigation contingent reporting will be under a microscope this financial reporting season." Young advised companies and their legal and auditing teams that rely on the "treaty" to nonetheless ensure the full requirements of ASC 450 are being fulfilled.

We at *SLR* think that is good advice.

In this issue… The April issue of *Securities Litigation Report* features authors Jordan Eth and Mia Mazza of Morrison Foerster LLP following up on the recent opinion from the Southern District of New York on several motions filed in the wake of the January 2010 jury verdict in *In re Vivendi Universal S.A. Securities Litigation*.

The jury, at that time, found that Vivendi Universal S.A. had committed securities fraud, but found no liability with respect to the French company's former CEO and CFO. Vivendi sought motion for judgment as a matter of law, or a new trial. Plaintiffs sought enforcement of the jury's verdict.

The authors discuss the judge's opinion on the motions, and how they have been impacted in the past 14 months by other court rulings, especially the June 2010 Supreme Court decision in Morrison v. National Australia Bank.

—JOSEPH M. MCLAUGHLIN & GREGG WIRTH

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Issue #1—Class Members Who Purchased on Foreign Exchanges

In 2003, the *Vivendi* court ruled that the § 10(b) claims of foreign class members who had purchased Vivendi securities on a foreign exchange ("F-Cubed" purchasers) would be allowed to move forward in the case.[3] The court rejected the defendants' argument that F-Cubed claims fall outside the extraterritorial scope of § 10(b). These F-Cubed purchasers made up the vast majority of the plaintiff class whose jury verdict was reported to be potentially worth several billion Euros.

In June 2010, while the parties' post-trial motions were pending, the Supreme Court's decision in *Morrison v. National Australia Bank*[4] came down, holding that § 10(b) does not apply to *any* transactions on foreign exchanges. In *Morrison*, the Supreme Court articulated a "transactional test" under which § 10(b) applies only to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities."[5]

Vivendi filed a supplement to its post-trial motion, seeking dismissal of the claims of all class members who had purchased Vivendi securities on a foreign exchange. The plaintiffs, facing the elimination of the bulk of their jury damages award, opposed the motion. The *Vivendi* plaintiffs' arguments in opposition are representative of arguments being made by similarly situated securities plaintiffs in at least 12 other cases pending or decided since *Morrison*.

First, the *Vivendi* plaintiffs argued that due to Vivendi's participation in a program whereby American Depositary Receipts (representing a certain number of underlying ordinary shares) were traded on the New York Stock Exchange (NYSE), § 10(b) should be applied to all transactions in the company's ordinary shares worldwide on any exchange. The plaintiffs argued that even though Vivendi ordinary shares were not available for trading on any exchange in the United States, all of Vivendi's ordinary shares were "listed on a domestic exchange," because Vivendi complied with NYSE's technical requirement that foreign issuers of ADRs list—not for trading—a corresponding number of the underlying ordinary shares on the NYSE.

In his February 17 opinion, Judge Holwell rejected plaintiffs' "listed" argument and dismissed the claims of all class members who had purchased Vivendi securities on a foreign exchange. The court found that the *Morrison* opinion as a whole adopted a test that turns on the territorial location of the subject transaction: "There is no indication that the *Morrison* majority read Section 10(b) as applying to securities that may be cross-listed on domestic and foreign exchanges, but where the purchase and sale does not arise from the domestic listing, particularly where (as here) the domestic listing is not even for trading purposes." The court noted that even under the "conduct" and "effects" tests that preceded *Morrison*, similar cross-listing scenarios would not by themselves support a § 10(b) claim. The court observed, "[i]t is unlikely that the *Morrison* court in any way intended to broaden the scope of section 10(b) when it replaced the conduct and effects tests."

Second, the *Vivendi* plaintiffs argued in the alternative that *Morrison* allowed the claims of Americans who had purchased Vivendi ordinary shares on a foreign exchange to go forward, under the "domestic transactions in other securities" prong of the transactional test. Judge Holwell rejected that argument as well: "The phrase 'domestic transaction' was intended to refer to the location of the transaction, not to the location of the purchaser. The Supreme Court clearly sought to bar claims based on purchases and sales of foreign securities on foreign exchanges, even though the purchasers were American."

In rejecting the claims of Americans who purchased on a foreign exchange, Judge Holwell stated that "[i]t simply blinks reality" to ignore Supreme Court Justice John Paul Stevens's concurring opinion in *Morrison*, which underscored the devastating impact of the majority's opinion on American investors who purchase shares abroad and fall victim to securities fraud. "If Justice Stevens had misinterpreted the Supreme Court's holding, one might have expected the majority opinion to address that misunderstanding. The majority's silence in this regard speaks volumes."

Vivendi is the eleventh of 12 district court decisions to find that *all* purchasers of securities on a foreign exchange are unable to state a claim under

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§10(b). It is the third of four cases to specifically reject the plaintiffs' argument regarding the term "listed" as used in *Morrison*'s transactional test.

Issue #2—Damages Calculation by Jury

There are very few securities fraud cases that have been tried to a jury verdict, and even fewer in which the jury calculated damages on a daily per-share basis. In *Vivendi*, both occurred. The jury verdict form provided a space for "per share" damages for each of the roughly 400 days in the class period. The plaintiffs' expert offered day-by-day calculations of per share damages numbers. The defendants' expert offered alternative numbers, if the jury found liability.

In our 2010 article, we noted two anomalies in the jury's calculation. First, although the jury's completed verdict form listed a "per share" damages number for each day in the class period, the numbers it listed did not match either expert's numbers. According to Vivendi's post-trial briefing, the jury "roughly halved the daily inflation figures" proposed by the plaintiffs' expert. Second, the jury found that there was inflation on September 10 and 29 of 2001, but that there was zero stock price inflation between September 11, 2001, and September 28, 2001. This means that a class member who (for example) purchased Vivendi stock on September 10 and then sold on September 17 was damaged by fraud, even though the *only* intervening event was a terrorist attack on the United States, an unlikely "corrective disclosure" of any alleged misstatement.

In § 10(b) case law, there historically have been few guideposts for proving damages at trial. Basic issues, such as whether the jury or the judge should decide on the method used to determine damages, and what latitude the jury should be given in making that determination, are rarely addressed. These issues were, however, addressed by Judge Holwell in the *Vivendi* opinion.

Regarding the jury's per-share damages calculations, Vivendi's post-trial motion argued that the jury's verdict reflected an impermissible compromise as to Vivendi's liability, warranting a new trial under Rule 59.[6] Rule 59 allows a district court to grant a new trial if the court concludes that the jury has reached a "seriously erroneous result" or that the verdict is a "miscarriage of justice." The denial of a motion for new trial is reviewed for "clear abuse of discretion."[7]

Judge Holwell acknowledged that a verdict must be set aside where jurors who cannot agree on liability compromise by agreeing to find liability but modify the damages award to reflect their unresolved disagreement. The court noted, however, that "the record itself viewed in its entirety must clearly demonstrate the compromise character of the verdict."

The court held that the record in *Vivendi* did not clearly demonstrate the compromise character of the jury's verdict, finding that "the computation of damages is a quintessential fact issue for the jury." The court noted that the jury never indicated to the court that it was deadlocked, and it observed that although there were 14 days of deliberations, that was not abnormal given the length and complexity of the trial.

The court further found that although the jury's per-share damage award itself "could support an inference of compromise," a compromise on the issue of liability "is not the only reasonable explanation for the verdict." Each side had experts who laid out daily inflation calculations and the basis for their determination of per share damages. The jury was never instructed that it was required to either accept or reject either expert's daily inflation calculations wholesale, and no party ever requested that the jury be so instructed. (Moreover, the court noted, a jury need not accept an expert's damage calculations wholesale.) The jury may have decided to reduce plaintiffs' expert's calculations of daily inflation, to account for the possibility that company-specific news unrelated to the fraud was responsible for some portion of the decline in Vivendi's stock prices. The jury could have believed it was permissible to award whatever sum the jury found to be reasonable, "and certainly that it was permissible to award any sum that fell within the range presented by the experts at trial."

Regarding the jury's finding of zero inflation in the stock price during the week following the terrorist attacks on September 11, 2001, Vivendi

argued that due to that finding it was entitled to a ruling as a matter of law that the class period ended on that date. Vivendi argued in the alternative that it was at least entitled to a new trial, as the jury must have misunderstood the court's instructions, and must not have understood that inflation could drop to zero only when the truth was fully reflected in the market price.

Judge Holwell held that the jury's finding that there was no inflation during a portion of the class period did not warrant a new trial. The court explained that the jury did not necessarily misunderstand the court's instructions—the jury may have concluded that plaintiffs' expert had not adequately taken into account the effects of 9/11 and wanted to make sure there were no damages being awarded during that time period. Or, the jury may have thought that the court's instructions precluded it from awarding any damages for which it was unable to make a reasonable estimate of the daily inflation.

The court acknowledged that there was a "legitimate concern[] about certain shareholders obtaining a windfall" as a result of the jury's finding of zero inflation on certain days in the middle of, as opposed to at the very end of, the class period. The court, however, referred to this as a "minor error" that did not justify a new trial. "An error on filling out the amount of the daily inflation on 9 of 454 days in the Class Period is not the type of 'miscarriage of justice' or 'seriously erroneous result' that would justify throwing out the entire jury verdict in this case." The court held that the consequences of the jury's erroneous finding can easily be addressed during the claims administration procedure.

Under these rulings in *Vivendi*, it is the parties' experts who determine what method for calculating damages will be presented to the jury. Judge Holwell's finding the computation of damages to be "a quintessential fact issue for the jury" reflects that, at least for purposes of *Vivendi*, the jury has broad discretion in determining which expert it believes and to what extent. Under this standard, a jury's damages numbers likely will be upheld unless they clearly reflect activity for which there is no reasonable explanation, resulting in manifest injustice. And even where the court finds an error in the jury's numbers, a court may dismiss the error as too "minor" to justify a new trial, a ruling subject to a "clear abuse of discretion" standard on appeal.

Issue #3—Company, but Not Individuals, Found Liable

The *Vivendi* jury found that the company had violated the securities laws with respect to all of the alleged misstatements, but that the two individual defendants—to whom most of the allegedly false statements were attributed—had not violated the securities laws at all. In our 2010 article, we noted that this finding raises questions about proving "corporate scienter," which securities litigators (and circuit courts) generally believe requires that an individual officer acting on behalf of the company acted with scienter.

In its post-trial motion, Vivendi sought JMOL on this basis under Rule 50—a failure of evidence of scienter as to Vivendi, in light of the verdicts in favor of Messrs. Messier and Hannezo. Under Rule 50, a defendant is entitled to judgment as a matter of law if, after the plaintiff has been fully heard on an issue during trial, the court finds that a reasonable jury would not have a legally sufficient evidentiary basis to find for the plaintiff on that issue. The court must (i) draw all reasonable inferences in favor of the nonmoving party; (ii) disregard all evidence favorable to the moving party that the jury is not required to believe; and (iii) conclude that a reasonable juror would have been compelled to accept the view of the moving party. The denial of JMOL is reviewed de novo, viewing the evidence in the light most favorable to the nonmoving party.[8]

The court ruled, however, that Vivendi's argument on this point was an "inconsistency" argument subject to the standard applicable to a motion for new trial under Rule 59. The Rule 59 standard for new trial is less stringent than the Rule 50 standard for JMOL—under Rule 59, a new trial may be granted even if there is substantial evidence supporting the jury's verdict, and a trial judge need not view the evidence in the light most favorable to the verdict winner. But Judge Holwell stressed that a motion for a new trial

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based on an inconsistency in the verdict must be raised before the jury is discharged; otherwise, the moving party waives its right to challenge the inconsistency after trial. The court explained that the reason for this waiver rule is to require a timely objection at the time the jury verdict is read, so that the asserted inconsistency may be cured without requiring a new trial. It appears from the record that Vivendi did not move for a new trial on grounds of an inconsistency in the verdict before the jury was discharged.

The court held that the inconsistency between the jury's verdict in favor of Messrs. Hannezo and Messier and its verdict against Vivendi did not warrant a new trial, for two reasons:

First, the court found that Vivendi had waived its right to bring this argument post-trial because it did not specifically object to the verdict on inconsistency grounds before the jury was excused. In its papers, Vivendi argued that it was not given an opportunity between the conclusion of the Court's reading of the verdict and discharge of the jury to raise any inconsistencies, but Judge Holwell stated in a footnote that the court found that argument "unpersuasive":

> **Counsel were provided with photocopies of the Verdict Form while the Court was reading the verdict into the record. That took considerable time, giving counsel ample opportunity to review the Verdict Form and identify potential inconsistencies before the jury was polled.[9]**

Vivendi also argued that it preserved an inconsistency argument on this point by objecting to the aspect of the jury verdict form that produced the inconsistency. The court held that in objecting to the verdict form Vivendi did not specifically argue that this structural problem could lead to this particular type of inconsistency in the verdict. For this reason, the court found that Vivendi's objection was not enough to satisfy the waiver requirement. (*See further discussion below*.)

Second, the court held that in any event the verdict was not inconsistent. It noted that an inconsistency challenge to a verdict will succeed only if the court is unable to determine any reasonable way to reconcile the jury's findings. The court then identified what it found to be a reasonable basis for reconciliation: a large number of documents were admitted against Vivendi but not against Messrs. Messier or Hannezo. Moreover, there were other documents that were admitted against Vivendi for all purposes but against Mr. Messier or Mr. Hannezo for only limited purposes. The court ruled that, based on these two factors, the jury could have found that plaintiffs had proven Vivendi's scienter under § 10(b) based on the scienter of Hannezo and Messier, even though the jury was unable to conclude that plaintiffs had met their burden of proof against Messrs. Hannezo or Messier individually.

Judge Holwell also analyzed this issue under the Rule 50 standard applicable to a motion for JMOL. In a lengthy analysis of the evidence introduced at trial, construing all inferences in favor of the plaintiffs and disregarding all facts the jury was not compelled to accept, the court held that the evidence at trial could reasonably have supported a finding of scienter against each of the individual defendants. The court found that the verdict "does not (and could not) establish that there was 'no proof' that Vivendi acted with scienter. Having reviewed the actual evidence in the record, the Court finds that the evidence was plainly sufficient to support a finding that Vivendi, through Messier and/or Hannezo, acted with scienter."

Issue #4—No Protection under the Reform Act's Safe Harbor

A fourth notable issue in the *Vivendi* ruling is the court's treatment of Vivendi's JMOL attack on the sufficiency of evidence of Vivendi's liability with respect to "forward looking statements."

Vivendi argued, under the JMOL standard, that it was entitled to protection under the Safe Harbor of the Private Securities Litigation Reform Act (Reform Act) with respect to 13 alleged misstatements. Under the Reform Act, a private securities fraud claim may not be based on forward-looking statements unless it is proven that the speaker had actual knowledge of the statement's falsity at the time the statement was made.[10]

The example that the court highlighted was the following statement from a Vivendi filing with the Securities and Exchange Commission (SEC): "it is also our objective to grow pro forma adjusted EBITDA at an approximate 35% compound annual growth rate through 2002."[11] Vivendi asserted that statements like this are "forward-looking statements" within the meaning of the Safe Harbor, and that they come within the protections of the Safe Harbor given the jury's finding that Vivendi had acted with recklessness as opposed to actual knowledge.

Judge Holwell disagreed with Vivendi, finding that the plaintiffs were not challenging the "forward-looking" aspect of each statement. The court relied on a recent case, *Iowa Pub. Emps' Ret. Sys. v. MF Global*, in which the Second Circuit held:

> **A statement may contain some elements that look forward and others that do not.... [I]n each instance the forward-looking elements and the non-forward looking are severable.[12]**

The court found that the *Vivendi* plaintiffs were challenging nonforward looking elements of the 13 alleged misstatements. Under the plaintiffs' theory, the announcement of the EBITDA target itself—regardless of the numbers involved—was misleading *as a matter of present fact* in that Vivendi failed to disclose that the projection included a one-time purchase accounting benefit that would account for almost 50% of EBITDA growth. The plaintiffs, pointing to internal documents, alleged that Vivendi had failed to disclose that the company's projection of EBITDA growth was not based on projected improvements in operations. The court found that in this sense the misleading nature of each statement could be verified the moment it was made, and did not depend on any future events, and thus the statement was not "forward-looking" within the meaning of the Reform Act's Safe Harbor.

With respect to the jury's finding of scienter based on recklessness and not actual knowledge, the court described this as another "inconsistency" argument properly treated under the standard applied to a motion for new trial, and it held that Vivendi had waived that argument by not asserting it before the jury's dismissal. Vivendi argued that it could not have waived this argument because it had objected to the aspect of the jury verdict form that produced the inconsistency. Without denying this fact, Judge Holwell found it was not dispositive of the waiver issue, which must be decided on a "case by case" basis—"the focus should be on determining whether an objection lodged at the time of verdict could have cured the alleged inconsistency without requiring a new trial."

Finally, the court held that even if the "actual knowledge" argument were appropriate to review as part of a motion for JMOL, the court found (based again on its own analysis of the evidence at trial, weighing all inferences in favor of the plaintiffs) that there was sufficient evidence in the record to have supported a jury finding that Messrs. Messier and Hannezo acted with actual knowledge.

Issue #5—The Jury Verdict Form

Throughout the court's opinion in *Vivendi*, aspects of the jury verdict form were discussed in connection with Vivendi's post-trial arguments.[13] The record reflects that the parties spent weeks negotiating the structure and content of the verdict form, and that the court intervened to resolve issues where the parties reached impasse. With the benefit of hindsight, five aspects of the *Vivendi* jury verdict form and the process that led to it stand out now as potentially useful in future securities trials:

First, the jury verdict form should be focused on alleged misstatements rather than omissions. In *Vivendi*, the plaintiffs tried to structure the jury verdict form so as to list just the facts the defendants allegedly failed to disclose. As Judge Holwell noted, however, § 10(b) cannot be violated by an omission on its own. The plaintiff must identify each affirmative statement or statements that allegedly were rendered misleading as a result of the omission. The court in *Vivendi* ordered the plaintiffs to provide that list in an appendix to the verdict form.

Second, the jury verdict form should identify each statement that will be at issue at trial, and

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ideally that list will be agreed upon by both parties before trial begins, to streamline the trial and allow the defendants an opportunity to prepare their defense. In *Vivendi*, the court ordered the plaintiffs to provide an appendix to the verdict form identifying the statements they would be asserting at trial as actionable, and providing an explanation of why plaintiffs believed each statement was materially misleading. One of Vivendi's post-trial arguments was that the plaintiffs had failed to provide this list until after the close of the evidence, depriving Vivendi of a fair trial.

Third, for each alleged misstatement identified in the verdict form, it is important for both parties to consider what level of detail the jury should be required to provide in completing the form. A very detailed verdict form may include a checklist directing the jury to make specific findings, for each statement, for each defendant, as to each element (and sub-element) of a § 10(b) violation. In *Vivendi*, the defendants fought for a verdict form that would require this level of detail. The court, however, found Vivendi's form to be "complex" and "unwieldy," opting for a simpler form that did not require the jury to make findings as to each element of each offense.

There may be tactical reasons for not requesting the highest level of detail in a verdict form. The court's ultimate rulings on Vivendi's post-trial motion, however, demonstrate the result of providing the jury with a less detailed verdict form: fact findings not specifically identified in the verdict form may need to be made by the court through its own post-trial weighing of the evidence in a light most favorable to the other side. Thus, in *Vivendi*, the verdict form did not ask the jury to identify, regardless of whether Messrs. Hannezo and Mercier were liable for securities fraud, whether those individuals acted with scienter. It also did not ask the jury to specify whether that scienter, if found, was based on recklessness or actual knowledge. When those issues became relevant post-trial, it was up to the court to decide whether there was sufficient evidence for a reasonable jury to have made those findings.

Fourth, to the extent the court does not allow for a party's requested detail in the verdict form or its structure, it is important that the party consider the inconsistencies that could result from its being deprived of the opportunity to provide clear guidance to the jury. Objections to the verdict form based on potential inconsistencies should then be made timely or, as was the case in *Vivendi*¸ those objections may be considered waived for purposes of a motion for new trial. *Vivendi* highlights several potential ways in which this result can play out. For example, Judge Holwell held that an objection based on the inconsistent verdict between individual and corporate scienter was waived, pointing to the fact that Vivendi had not specifically argued that a less detailed jury verdict form could lead to that particular type of inconsistency. Requiring this level of specificity to preserve the right to request a new trial may result in the verdict form drafting process to be even longer and more drawn-out than it already is, as each party attempts to identify all potential negative outcomes of its own structure not being adopted in full.

Finally, even where full and complete objections to unfavorable aspects of a jury verdict form are made, under *Vivendi* an "inconsistency" objection might still be found to have been waived if it is not renewed when the jury's actual verdict is read. Judge Holwell found Vivendi's objection to an inconsistency in the jury's verdict on the Reform Act's Safe Harbor provision to have been waived on this basis. (Note that in *Vivendi*, after the jury's verdict was read out loud, the court did not provide the parties with additional time to consider whether there were inconsistencies in the verdict that needed to be brought to the court's attention before the jury's discharge.)

Conclusion— What's Next in *Vivendi*?

As outlined in this article, there are several issues that are likely to be raised by each party on appeal in *Vivendi*. Even though the plaintiffs' only loss was on the *Morrison* issue, they likely lost more post-trial ground than Vivendi because the *Morrison* issue removed the vast majority of the plaintiff class.

Perhaps in hopes of a speedy appeal of the district court's ruling on the *Morrison* issues, the *Vi-*

vendi plaintiffs moved for entry of final judgment. Vivendi objected to that motion as brought prematurely, arguing that Vivendi is entitled to rebut the presumption of reliance on an individual basis with respect to each class member.

The court agreed with Vivendi, holding that "issues of individual reliance can and should be addressed after a class-wide trial, through separate jury trials if necessary." While Vivendi did not challenge the individual reliance of each class member at trial, and the court did not issue a formal order before trial clarifying that issues of individual reliance were reserved for after the class trial, the court held that the absence of those factors was not dispositive. "[A]ll parties were on notice that individual reliance issues might require resolution in separate proceedings after the class trial."

The court did not identify what procedures should be used during the individual reliance trials. It acknowledged the possibility that "the methods for calculating an individual claimant's damages will be hotly contested and may trigger additional appeals."

As few cases as there are in which a securities trial reached a jury verdict in favor of the plaintiffs, there are even fewer securities cases to reach the stage of attempting to rebut the presumption of reliance on an individual basis postverdict. Depending on how the court winds up structuring this inquiry, *Vivendi* may end up providing some of the only guidance in the area.

NOTES

1. Eth, Mazza, and Sprenkel, "The *Vivendi* Verdict: Three Key Issues," *Securities Litigation Report*, © West Services, Inc. (*a division of Thomson Reuters*); (Vol. 7, Issue 3) (March 2010).
2. *In re Vivendi Universal, S.A. Securities Litigation*, 2011 WL 590915 (S.D. N.Y. 2011) (*Vivendi*). For ease of readership, this article simplifies certain aspects of the facts, arguments, and rulings in *Vivendi*.
3. *In re Vivendi Universal, S.A.*, 381 F. Supp. 2d 158, Fed. Sec. L. Rep. (CCH) P 92619 (S.D. N.Y. 2003).
4. *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869, 177 L. Ed. 2d 535, Fed. Sec. L. Rep. (CCH) P 95776, R.I.C.O. Bus. Disp. Guide (CCH) P 11932, 76 Fed. R. Serv. 3d 1330 (2010) (Morrison).
5. *Morrison*, 130 S. Ct. at 2884-8286.
6. All references to "Rules" are to the Federal Rules of Civil Procedure.
7. *Kode v. Carlson*, 596 F.3d 608, 612 (9th Cir. 2010).
8. *Howard v. Walgreen Co.*, 605 F.3d 1239, 1242, 109 Fair Empl. Prac. Cas. (BNA) 477, 93 Empl. Prac. Dec. (CCH) P 43882, 76 Fed. R. Serv. 3d 1083 (11th Cir. 2010).
9. *Vivendi*, 2011 WL 590915 at *46 n.49.
10. Private Securities Litigation Reform Act, 15 U.S.C.A. § 77z-2(c)(1)(B)(ii).
11. *Vivendi*, 2011 WL 590915 at*44.
12. *Iowa Public Employees' Retirement System v. MF Global, Ltd.*, 620 F.3d 137, 144, Fed. Sec. L. Rep. (CCH) P 95855, 77 Fed. R. Serv. 3d 655 (2d Cir. 2010).
13. *See* Jury Verdict Form, *In re Vivendi* (S.D.N.Y. Feb 4, 2010) (No. 02-cv-5571).

Delaware Chancery Court Update:

Recent Decisions Shed New Light on Stapled Financing Offered by Financial Advisors, Duties of Directors with Respect to Poison Pills

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On February 14 and February 15, respectively, the Delaware Court of Chancery issued two opinions that shed further light on two issues that directors of corporations regularly confront when considering a potential change of control transaction. First, the court in *In re Del Monte Foods*

Company Shareholders Litigation[1] addressed concerns that potentially arise when a financial advisor provides stapled financing in connection with a transaction on which it advises. Second, *Air Products & Chemicals, Inc. v. Airgas, Inc.*[2] addressed under what circumstances a board of directors may refuse to redeem a poison pill in the face of a structurally noncoercive, all cash tender offer. Both decisions, while addressing disparate issues, further illuminate the contours of directors' fiduciaries duties in the particular context in which they arise.

In re Del Monte Foods Company Shareholders Litigation

In *Del Monte*, the court considered a motion to enjoin preliminarily an acquisition of Del Monte Foods Company by a consortium of private equity firms. The parties had agreed to a leveraged buy-out, through which Del Monte shareholders would receive $19 per share in cash, which represented a 40% premium over the average closing price of Del Monte stock prior to the announcement of the proposed transaction. Prior to commencing negotiations concerning the transaction, the board of directors of Del Monte retained an investment banking firm to provide advice with respect to a potential transaction.

However, the court concluded that, unbeknownst to the Del Monte board, from the outset, the investment bank hoped to provide lucrative buy-side financing for whomever consummated a deal with Del Monte. The court found that the bank steered the process to enhance its opportunity to provide buy-side financing. The court noted that the investment bank recommended to Del Monte's board that it explore transactions with private equity buyers to whom the investment bank had a possibility to provide financing. The board proceeded to engage in discussions with these private equity buyers, and each signed a confidentiality agreement that prevented it from joining with another buyer to bid for the company without the prior permission of the board (called a "No-Teaming Provision"). The confidentiality agreement also included a (not unusual) provision that allowed the bidders to discuss financing only with Del Monte's investment bank. The court concluded that this provision worked to the bank's advantage in its attempt to secure buy-side financing because the bank expressed its interest in providing financing to the potential buyers.

After signing the confidentiality agreement, five private equity firms submitted indications of interest. The primary private equity fund, which was the second-highest bidder, stated that its bid contemplated "newly raised debt in line with the guidance provided by" the investment bank.[3] The firm that submitted the highest bid stated that it needed to pair up with another private equity buyer. Del Monte's board considered all the proposals and decided that it was best to continue as a stand-alone company. It instructed its investment bank to "shut [the] process down and let buyers know the company is not for sale."[4] Undeterred, however, the primary private equity fund continued to contact Del Monte to express its interest in a deal.

A few months later, the investment bank, on its own initiative, suggested to the previous highest bidder firm that it pair up with the primary private equity fund so they could approach Del Monte together, presumably to make a more attractive bid. Noting that this tactic violated the No-Teaming Provision in the confidentiality agreement the parties had signed, the court concluded that by pairing the primary private equity fund and the highest bidder together, the investment bank "put together the two highest bidders… thereby reducing the prospect of real competition in any renewed process."[5]

The primary private equity fund, along with a third private equity buyer, thereafter submitted a bid to Del Monte. The bid did not mention the highest bidder firm, as the primary private equity fund and the third private equity buyer had agreed not to disclose their cooperation with that firm. Del Monte's board met and decided to consider the primary private equity fund's bid. For various reasons, the board determined to negotiate with the primary private equity fund, but not to open up the process to other bidders. According to the court, the investment bank did not tell the board that it had been communicating with both the primary private equity fund and the

highest bidder firm and that it had put the two firms together.

As the likelihood of a deal became more apparent, the primary private equity fund "formally" approached the investment bank to request the Del Monte's board permission that the highest bidder firm join its and the third private equity buyer's bid. "No one suggested that adding [the highest bidder firm] was necessary for [the primary private equity fund] to proceed with its bid. There is no evidence that including [the highest bidder firm] firmed up a wavering deal."[6] Del Monte's board was not informed of the highest bidder firm's earlier involvement, it did not consider the effect the highest bidder firm's involvement could have on the deal, and it did not consider rejecting the primary private equity fund 's request. The board did not "seek to trade permission for [the highest bidder firm] to pair with [the primary private equity fund] for a price increase or other concession."[7]

Around the same time, the primary private equity fund agreed to give Del Monte's investment bank one-third of the debt financing. The next day, the bank asked Del Monte if it could provide buy-side financing and Del Monte agreed. At the time the bank received permission to provide buy-side financing, Del Monte and the primary private equity fund had not agreed on price. The bank's financing was not needed for the deal, and it was not used to extract a higher price. All told, the investment bank would receive between $21 million and $24 million from buy-side financing, in addition to the $23.5 million it earned as a sell-side advisor. Also, because the bank's provision of buy-side financing created a conflict of interest, Del Monte was forced to retain a second bank to provide a fairness opinion, which cost an additional $3 million.

Eventually, Del Monte and all three firms agreed on price and negotiated a merger. The merger agreement included, among standard deal protection measures, a "go-shop" provision, and the investment bank ran the go-shop. Given its financing arrangements, the court indicated that the bank would earn more from a deal with the three firms than any other strategic alternative. As such, the court determined that the investment bank had little incentive to locate a competing bidder. At one point, another bank expressed interest in running the go-shop. That bank was offered to participate in the financing, which "squared things away there," as it thereafter dropped its interest in running the go-shop.[8]

Based on the findings from the evidence submitted, the court issued a limited preliminary injunction enjoining the deal protection measures in the merger agreement for a limited time. The court reasoned that Del Monte's board was required to show under an "enhanced scrutiny" standard (i) "that its motivations were pure and not selfish," and (ii) that board "sought 'to secure the transaction offering the best value reasonably available for the stockholders.'"[9] To show they sought to secure the best value for the shareholders, the board must "demonstrate that 'their actions were reasonable in relation to their legitimate objective.'"[10] Courts require a "reasonable decision, not a perfect decision."[11]

The court found on a preliminary basis that the Del Monte board failed this standard, thereby breaching its fiduciary duties, because it failed to exercise sufficient oversight over its investment bank. As in other decisions, the court seemed to view the practice of stapled financing with suspicion.[12] Although noting that such financing does not *per se* create a disabling conflict of interest for a financial advisor, "it is advisable that investment banks representing sellers not create the appearance that they desire buy-side work, especially when it might be that they are more likely to be selected by some buyers for that lucrative role than by others."[13]

While acknowledging that the Del Monte board was unaware of the facts upon which the court based its ruling, the court found a breach by the board because ultimately, the "buck stops with the Board."[14] The court observed that the board failed to inquire and contemplate adequately before giving permission to the primary private equity fund to team with the highest bidding firm and before giving the bank permission to provide buy-side financing. Although boards generally may rely in good faith on their advisors, when they are not sufficiently informed by those advisors, "the protections girding the decision itself

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vanish. Decisions made on such a basis are voidable at the behest of innocent parties."[15] Consequently, "the director defendants failed to act reasonably in connection with the sale process."[16] Although the court expressed skepticism that the directors could be subject to money damages, it enjoined the transaction to allow competing bidders to emerge.

Several lessons are to be learned from *Del Monte*. For one thing, it invites directors to proceed with caution in granting requests from financial advisors to engage in buy-side financing. Unless there is some reason why the financing is necessary to finance the deal or unless the buy-side participation can extract a higher price or other concessions,[17] boards are well-advised to "nix[] that idea."[18] If directors do agree to allow buy-side financing, they should take steps to "protect the integrity of the process."[19] Such steps may include "limit[ing] the role" of the bank's lending group, "chaperon[ing] its discussions with bidders, or [using] another bank to provide confidential feedback to the potential sponsors about leverage parameters and market expectations."[20] Timing may also be a consideration. Of particular concern to the court in *Del Monte* was that Del Monte's board granted the investment bank permission to provide buy-side financing while the parties were still negotiating over price. This created a direct conflict of interest (the bank "had an incentive as a well-compensated lender to ensure that a deal was reached that the [the three firms] did not overpay") during a critical time in the negotiations.

Del Monte also serves as a caution to directors that they bear ultimate responsibility for the direction of the sales process. Thus, the board must take an "active and direct role in the sale process."[21] While financial advisors are no doubt essential to the process, directors must be aware that their advisors are "not necessarily impartial."[22]

As an interesting side note, a similar concern about ensuring transparency with respect to a financial advisor's "interest" in a potential transaction where the sell-side advisor was the sole fairness opinion provider led the Delaware Court of Chancery a few weeks later in *In re Atheros Communications, Inc. Shareholder Litigation* to issue a preliminary injunction requiring additional disclosures concerning the financial advisor's compensation.[23] The court required the parties to disclose that 98% of the financial advisor's compensation was contingent on the closing of the deal. The court reasoned: "Contingent fees are undoubtedly routine; they reduce the target's expense if a deal is not completed; perhaps, they properly incentivize the financial advisor to focus on the appropriate outcome. Here, however, the differential between compensation scenarios may fairly raise questions about the financial advisor's objectivity and self-interest."[24]

Air Products & Chemicals, Inc. v. Airgas, Inc.

In *Air Products*, the shareholders of Airgas, Inc. were faced with an all-cash, fully financed tender offer from Air Products & Chemicals, Inc. The tender offer was structurally noncoercive, meaning there was no threat that "disparate treatment among non-tendering shareholders might distort shareholders' tendering decisions."[25] It was undisputed that the shareholders had all the information they needed in order to make a decision with respect to that tender offer, including information concerning the stated belief of the Airgas board of directors that the price offered was clearly inadequate by at least $8 per share. It was also clear that, if given an opportunity to tender, a majority of Airgas shareholders, even knowing that the Airgas board believed the offer was inadequate, would tender in response to the offer. Despite these facts, the Airgas board refused to redeem Airgas' poison pill to allow the tender offer to go forward.

The issue before the court was whether the Airgas board, in keeping the poison pill in place, acted in accordance with its obligations under *Unocal Corp. v. Mesa Petroleum Co.*,[26] which requires that "to justify its defensive measures [taken against a hostile takeover], the target board… show (1) that it has 'reasonable grounds' for believing a danger to corporate policy and effectiveness existed; (*i.e.* the board must articulate a legally cognizable threat) and (2) that any board

action taken in response to that threat is 'reasonable in relation to the threat posed.'"[27] After a full trial, the court concluded that it did.

First, the court concluded that the Airgas board satisfied the first prong of *Unocal* by showing that it conducted a good faith and reasonable investigation and reached a reasonable result in believing that a "legitimate threat" existed. A threat may exist when an offer (i) is "structurally coercive," which the Air Products offer was not, (ii) presents the potential for a lost opportunity, such as the opportunity to select a superior opportunity offered by management, or (iii) is "substantively coercive." The court placed great emphasis on prior decisions by the Delaware Supreme Court recognizing that an offer may be "substantively coercive" if its price is inadequate. "[T]he directors of a Delaware corporation have the prerogative to determine that the market undervalues it stock and to protect its stockholders from offers that do not reflect the long-term value of the corporation under its present management plan."[28] The Airgas board, which consisted of a majority of outside independent directors, had conducted a thorough inquiry into the value of Airgas stock over time, and therefore reasonably believed that the Air Products offer was inadequate.[29] Significantly, Air Products had pursued a successful proxy challenge to unseat three members of Airgas' board, and the independent board members sponsored by Air Products agreed too that the offer was inadequate.

In reaching the conclusion that the board reasonably perceived the inadequate Air Products offer as substantively coercive, the court commented that the concept of substantive coercion had apparently migrated from its original meaning. As originally conceived—and as some commentators argue should be the case—substantive coercion required more than mere inadequate price (which a fully informed shareholder is free to accept or reject). It required some danger that a better deal was coming along, but the shareholders would feel pressured or confused to act now, before all the relevant information was revealed. The court questioned whether the changes in the law made sense, commenting that now that all relevant information had been revealed, the only purpose remaining for the Airgas pill was to preclude "the shareholders from tendering into Air Products' offer,"[30] many of whom were hedge funds or arbitrageurs less concerned with the long-term. Nonetheless, the court felt constrained by Delaware Supreme Court precedent.

The court then determined that the Airgas board also satisfied the *Unocal*'s second prong. First, the court found that the Airgas directors met their burden of proving that the action in maintaining the poison pill was neither preclusive nor coercive and otherwise fell within a "range of reasonableness."[31] Noting that coercion can arise when the board is attempting to "cram[] down" a management-sponsored initiative, the court found that Airgas' action in refusing to redeem the poison pill merely maintained the status quo. The court also found the refusal to redeem the poison pill was not preclusive because it did not render Air Products' "ability to wage a successful proxy context and gain control [of the target's board] realistically unattainable."[32] While Airgas' staggered board meant that Air Products could not gain control of the board in the very near future, the court cited Delaware Supreme Court authority holding that "the combination of a classified board and [a poison pill] do not constitute a preclusive defense."[33] In other words, mere delay in being able to take over the board is not sufficient to make a defense preclusive.

Finally, the court concluded that keeping the pill in place was within the range of reasonableness. Even those Airgas directors nominated by Air Products agreed that the tender offer undervalued Airgas stock. They had no reason to believe that their fellow directors were breaching their duties. Rather, they believed that, notwithstanding the amount of information available to stockholders, Airgas management was in the best position to understand the value of the company. Under such circumstances, the board was free to act in good faith and on an informed basis to pursue the long-term strategy it had conceived for the company.

The court, in reflecting on the case before it and its decision, commented that, ultimately, the case was about when, if ever, the board of a company can "just say never" to a hostile tender offer.[34] While, as the court pointed out, a board

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can never *just* say never (it must pass the scrutiny of *Unocal*), the court's decision reflects that there are circumstances when a poison pill may allow a board to defeat a tender offer indefinitely in order to pursue its own long-term strategy.

While the decision raises interesting philosophical issues regarding shareholder democracy, at least for now, it appears that the directors may, consistent with their fiduciary duties, decline to heed the voice of the majority. As noted by the court, the directors, not the shareholders, are ultimately responsible for managing the company, and they need not "jettison [their] place and put the corporation's future in the hands of its stockholders."[35] Nor may the board be "thrust involuntarily into a *Revlon* mode in which [it is] required to take only steps designed to maximize current share value and in which it must desist from steps that would impede that goal, even if they might otherwise appear sustainable as an arguable step in the promotion of 'long term' corporate or share values."[36]

NOTES

1. *In re Del Monte Foods Co. Shareholders Litigation*, 2011 WL 532014 (Del. Ch. 2011).
2. *Air Products and Chemicals, Inc. v. Airgas, Inc.*, 2011 WL 806417 (Del. Ch. 2011).
3. *In re Del Monte*, 2011 WL 532014 at *6.
4. *In re Del Monte*, 2011 WL 532014 at *7.
5. *In re Del Monte*, 2011 WL 532014 at *7.
6. *In re Del Monte*, 2011 WL 532014 at 10.
7. *In re Del Monte*, 2011 WL 532014 at *10.
8. *In re Del Monte*, 2011 WL 532014 at *12.
9. *In re Del Monte*, 2011 WL 532014 at *15.
10. *In re Del Monte*, 2011 WL 532014 at *15.
11. *In re Del Monte*, 2011 WL 532014 at *15.
12. *In re Del Monte*, 2011 WL 532014 at *16; *see also In re Toys "R" Us, Inc. Shareholder Litigation*, 877 A.2d 975 (Del. Ch. 2005); *Ortsman v. Green*, 2007 WL 702475, at *1 (Del. Ch. 2007); *Khanna v. McMinn*, 2006 WL 1388744, at *25 (Del. Ch. 2006); *In re Prime Hospitality, Inc.*, 2005 WL 1138738, at *12 (Del. Ch. 2005).
13. *In re Del Monte*, 2011 WL 532014 at *16 (quoting *Toys "R" Us.*, 877 A.2d at 1006 n.46).
14. *In re Del Monte*, 2011 WL 532014 at *19.
15. *In re Del Monte*, 2011 WL 532014 at *20.
16. *In re Del Monte*, 2011 WL 532014 at *20.
17. *In re Del Monte*, 2011 WL 532014 at *10.
18. *In re Del Monte*, 2011 WL 532014 at *17.
19. *In re Del Monte*, 2011 WL 532014 at *17.
20. *In re Del Monte*, 2011 WL 532014 at *17.
21. *In re Del Monte*, 2011 WL 532014 at *19.
22. *In re Del Monte*, 2011 WL 532014 at *19.
23. *In re Atheros Communications, Inc. Shareholder Litigation*, C.A. No. 6124-VCN, slip op. (Del. Ch. Mar. 4, 2011).
24. *Atheros*, slip op. at 23.
25. *Air Products*, 2011 WL 806417 at *36.
26. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, Fed. Sec. L. Rep. (CCH) P 92046, Fed. Sec. L. Rep. (CCH) P 92077 (Del. 1985).
27. *Air Products*, 2011 WL 806417 at *25 (quoting *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, Fed. Sec. L. Rep. (CCH) P 98,519 (Del. 1995)).
28. *Air Products*, 2011 WL 806417 at *40 (quoting *Unitrin*, 651 A.2d at 1376)); *see also Yucaipa American Alliance Fund II, L.P. v. Riggio*, 1 A.3d 310 (Del. Ch. 2010), judgment aff'd, 2011 WL 743427 (Del. 2011) (concluding that threat was reasonable when large shareholder quickly amassed greater holdings, posing a threat that it could exert control without paying control premium).
29. *Compare with eBay Domestic Holdings, Inc. v. Newmark*, 2010 WL 3516473, at *12 (Del. Ch. 2010) (concluding that despite reasonable investigation, belief that a threat existed as to unique corporate culture not sufficient to justify poison pill).
30. *Air Products*, 2011 WL 806417 at *33.
31. *Air Products*, 2011 WL 806417 at *40.
32. *Air Products*, 2011 WL 806417 at *40 (quotations omitted).
33. *Air Product*, 2011 WL 806417*s* at *41 (quoting *Versata Enterprises, Inc. v. Selectica, Inc.*, 5 A.3d 586, 604 (Del. 2010)); *see also Riggio*, 1 A.3d at 353-354 (concluding that poison pill enacted with staggered board in place was not preclusive even though proxy contestant needed to garner a supermajority of votes to win).
34. *Air Products*, 2011 WL 806417 at *1.
35. *Air Products*, 2011 WL 806417 at *39 n.427 (quoting *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1149-1150, Fed. Sec. L. Rep. (CCH) P 94938 (Del. 1989)).
36. *Air Product*, 2011 WL 806417*s* at *34.

Second Circuit's *MBIA* Decision Forces Defendants to Choose Whether Securities Fraud Claims are Time-barred or Not Properly Pled

BY CHRISTIAN SIEBOTT & BRIAN LEHMAN

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In the aftermath of massive corporate scandals at Enron and other companies, Congress passed the Sarbanes-Oxley Act of 2002. Among other things, Congress extended the one-year statute of limitations and three-year statute of repose for securities fraud claims. The United States Code now states that a federal claim of securities fraud "may be brought not later than the earlier of" either "2 years after the discovery of the facts constituting the violation" or "5 years after such violation."[1]

Last term, in *Merck & Co. v. Reynolds*,[2] the U.S. Supreme Court held that "discovery" means "(1) when the plaintiff did in fact discover, or (2) when a reasonably diligent plaintiff would have discovered, 'the facts constituting the violation'—whichever comes first."[3] But what does the phrase "the facts constituting the violation" mean?

In *City of Pontiac General Employees' Retirement System v. MBIA, Inc.*, the U.S. Court of Appeals for the Second Circuit became the first circuit court after *Merck* to answer this question.[4] The Second Circuit held that "a fact is not deemed 'discovered' until a reasonably diligent plaintiff would have sufficient information about that fact to adequately plead it in a complaint."[5] Under *MBIA*, defendants may not move to dismiss for failure to properly plead a claim and, at the same time, argue that the statute of limitations bars the claim. As the Second Circuit explained, "the reasonably diligent plaintiff has not 'discovered' one of the facts constituting a securities fraud violation until he can plead that fact with sufficient detail and particularity to survive a 12(b)(6) motion to dismiss."[6]

The Second Circuit's decision is well-founded. The Supreme Court's decision in *Merck*, as well as the purpose of a statute of limitations, supports this interpretation. Moreover, although not mentioned by the Second Circuit, the phrase "facts constituting the violation" has a specific historical meaning: Based on the New York Code of 1848, or "Field Code," it refers to facts that, if alleged in a complaint, state a claim.[7] Finally, because the five-year statute of repose begins to run as soon as the defendant commits the violation (*i.e.*, breaks the law), plaintiffs still have an incentive to investigate and file a complaint quickly.

Background on *MBIA*

MBIA, Inc. is a company based in Armonk, New York, that sells insurance guaranteeing the principal and interest on bonds, and thereby allows its customers to pay lower interest rate on bonds they issue. In 1998, one of MBIA's major policyholders defaulted on a bond and left MBIA with a $170 million debt. The loss was allegedly so large that it threatened MBIA's Triple-A credit rating.

To avoid having its credit rating lowered, MBIA made a deal with three European reinsurance companies (companies that sell insurance to insurance companies). The three companies allegedly agreed to pay the $170 million loss by reinsuring MBIA on the bonds "*nunc pro tunc*"—that is, retroactively. In turn, MBIA immediately paid $3.85 million and agreed to purchase reinsurance on low-risk bonds over a six-year period for $297 million. "MBIA initially booked this

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odd transaction ('1998 transaction') as income, and it continued to do so in its SEC Form 10-Ks from 1998 through 2003."[8]

In the years that followed, the financial press—market analysts, ratings agencies, and news outlets—discussed the fact that MBIA had agreed to pay premiums for reinsurance policies in exchange for a $170 million up-front payment. Some of these comments were positive or ambivalent, but some articles suggested that the 1998 transaction was actually a loan. For example, on December 9, 2002, a hedge fund investor issued a research report that concluded "this mechanism is not in fact reinsurance, but rather a loss-deferral, earnings-smoothing device."[9] The Securities and Exchange Commission (SEC) and the New York Attorney General eventually investigated MBIA's accounting practices. In the spring of 2005, MBIA publicly restated its financials for 1998 through 2003 so that the 1998 transaction was booked as a loan instead of as income.

In April 2005, investors sued MBIA and various corporate officers for securities fraud in violation of § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. The suing investors proposed to represent a class of all individuals who purchased stock in MBIA between August 5, 2003, and March 30, 2005. The defendants moved to dismiss on the ground that the securities fraud claim was barred by 28 U.S.C.A. § 1658(b) as the investors had not brought the fraud claim "(1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation."[10] The defendants also argued that the investors had failed to satisfy the pleading requirements of the Federal Rule of Civil Procedure and the Private Securities Litigation Reform Act of 1995.

The district court granted the motion to dismiss on the ground that the two-year statute of limitations barred the claim. According to the district court, the hedge fund's December 9, 2002, report placed the plaintiffs on "inquiry notice" that would have led a reasonably diligent plaintiff to investigate further. Under Second Circuit precedent, the statute of limitations started running on the day the plaintiffs should have begun investigating and, thus, the claim was barred.

The Second Circuit's Interpretation of "Facts Constituting the Violation"

The plaintiffs in *MBIA* appealed the district court's order and, before the Second Circuit issued its decision, the Supreme Court overruled the Second Circuit's inquiry notice standard. In *Merck*, the Supreme Court held that discovery does not mean when a reasonable person should have started investigating for fraud, but rather when "a reasonably diligent plaintiff would have discovered the facts constituting the violation, including scienter—irrespective of whether the actual plaintiff undertook a reasonably diligent investigation."[11]

Merck left two questions open, however. As explained by the Second Circuit in *MBIA*:

A. What are the facts that together constitute a securities fraud violation for purposes of commencing the statute of limitations?

B. With regard to any particular one of these facts, how much information does the reasonable investor need to have about it before it is deemed "discovered" for purposes of commencing the statute of limitations?[12]

In answering these questions, the Second Circuit found that *Merck* provided "some guidance."[13] In its decision, the Second Circuit said:

> ***Merck* specifically considered scienter, casting discovery of scienter in terms of what information and evidence a plaintiff would need to survive a motion to dismiss.**[14]

And:

> **The fact that *Merck* specifically referenced pleading requirements when discussing the limitations trigger indicates to us that the *Merck* Court thought about the requirements for 'discovering' a fact in terms of what was required to adequately plead that fact and survive a motion to dismiss.**[15]

The Second Circuit found that its interpretation was also supported by the basic purpose of a statute of limitations by preventing plaintiffs

from unfairly surprising defendants by resurrecting stale claims. "Since the purpose is to prevent stale claims, it would make no sense for a statute of limitations to begin to run before the plaintiff even has a claim: A claim that has not yet accrued could never be considered stale."[16] The Second Circuit concluded "a fact is not deemed 'discovered' until a reasonably diligent plaintiff would have sufficient information about that fact to adequately plead it in a complaint."[17] The Second Circuit remanded the case for reconsideration in light of *Merck* and its opinion.

The Historical Meaning of "Facts Constituting the Violation" and § 1658(b)'s Statute of Repose

Although not mentioned by the Second Circuit, its interpretation is correct for two additional reasons:

First, the Second Circuit's interpretation of "facts constituting the violation" is consistent with the phrase's historical meaning. When Congress passed § 1658(b), it based the statute on a provision of the Securities Exchange Act of 1934 that stated:

> **No action shall be maintained… unless brought within one year after the discovery of the facts constituting the violation and within three years after such violation.[18]**

Congress enacted this provision four years before the Federal Rules of Civil Procedure became effective and when the Field Code was in regular use.

The phrase "facts constituting" is based on the Field Code's requirement of what a litigant had to plead in his initial filing. To begin a lawsuit, a plaintiff had to include "[a] statement of the *facts constituting* the cause of action."[19] In other words, the historical meaning of "facts constituting the violation" refers to when an investor can state his claim.

Indeed, in a case related to *Merck*, the United States submitted an *amicus* brief that reached the same conclusion. According to the *amicus* brief, the phrase is "naturally understood to refer to facts that, if pleaded in a securities-fraud complaint, would be sufficient to survive a motion to dismiss."[20] While it is probably an overstatement to say the phrase may be "naturally" understood to mean anything, given that people do not ordinarily use this phrase, it does have a historical meaning that courts may presume was incorporated into the statute of limitations.

Second, investors still have an incentive not to delay the investigation and filing of their complaints. Under the plain language of the statute, the five-year statute of repose for defendants begins to run as soon as they commit the violation. In *MBIA*, for example, the first violation was arguably committed the first time that MBIA made a misstatement about the 1998 transaction being income rather than a loan. Investors harmed by such a misstatement would only have five years to file a claim even if they had not, or could not have, discovered that they had a claim.

In sum, the Second Circuit's interpretation of "facts constituting the violation" eliminated defendants' ability to move to dismiss on the ground that the plaintiffs failed to properly plead a claim as well as bring a timely claim. Nonetheless, the decision is supported by the Supreme Court's decision in *Merck*, consistent with the historical meaning of the phrase, and unlikely to cause investors to significantly delay investigating and filing their claims.

NOTES

1. United States Code, 28 U.S.C.A. § 1658(b).
2. *Merck & Co., Inc. v. Reynolds*, 130 S. Ct. 1784, 176 L. Ed. 2d 582, Fed. Sec. L. Rep. (CCH) P 95733 (2010).
3. *Merck*, 130 S. Ct. at 1789-1790.
4. *City of Pontiac General Employees' Retirement System v. MBIA, Inc.*, 2011 WL 677404 (2d Cir. 2011).
5. *MBIA*, 2011 WL 677404 at *4.
6. *MBIA*, 2011 WL 677404.
7. 1848 N.Y. Field Code Laws ch. 379, § 142, amended by ch. 438 (1949).
8. *MBIA*, 2011 WL 677404 at *1.
9. *In re MBIA Inc.*, 2007 WL 473708, at *4 (S.D. N.Y. 2007) (quoting Gotham Partners Management Co., *Is MBIA Triple-A?, A Detailed Analysis of SPVs, CDOs, and Accounting and Reserving Policies at MBIA, Inc.* at 47-48 (2002)).
10. 28 U.S.C.A. § 1658(b).

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11. *Merck*, 130 S. Ct. at 1798 (internal quotation marks omitted).
12. *MBIA*, 2011 WL 677404 at *3.
13. *MBIA*, 2011 WL 677404 at *4.
14. *MBIA*, 2011 WL 677404.
15. *MBIA*, 2011 WL 677404.
16. *MBIA*, 2011 WL 677404.
17. *MBIA*, 2011 WL 677404.
18. The Securities Exchange Act of 1934; 15 U.S.C.A. § 78i(f).
19. Charles E. Clark, *The Complaint in Code Pleading*, 35 YALE L.J. 259, 291 (1926) (*emphasis added*).
20. Brief for the United States as *Amicus Curiae* Supporting the Respondent, *Trainer Wortham & Co. v. Betz*, No. 07-1489, 2009 WL 1090416, at *9 (Apr. 20, 2009).

Trial or Settle? The Integrated e-Discovery Experience vs. Other Methods

BY MATT BERRY

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As the complexity of a process increases, so typically does the related cost and needed expertise. With e-discovery, this complexity can increasingly intrude on a company's options to pursue costly litigation. Companies and law firms are battling the sheer amount of data that is produced in the typical workplace. This data is growing exponentially as e-mail, chat, and even mobile messaging supplant paperwork or old fashioned conversations as the communication methods of choice. As the amount of available data rises, the complexities of managing, organizing, and dissecting the data follows a similar trajectory. Because of the high cost of typical piecemeal e-discovery processes, many companies quickly realize these costs can surpass the payout of a settlement. They might have the willingness and strong case to bring the issue to trial, but the economics often just do not make sense. Putting together a better e-discovery plan will allow companies and firms to cut into costs and focus on the actual defense of those cases and will minimize the disruption in business operations for the nonlegal team members, allowing them to continue focusing on their day-to-day tasks.

Where to Start

Legal issues are no longer just the concern of the legal department. When lawsuits present themselves, the information technology (IT) team needs to be up-to-date on the best practices for collecting and archiving documents that might be used in any litigation. Performing quality e-discovery is still complex and requires technical expertise that will only be found from trained and reliable staff. Legal and IT need to proactively work together to implement document retention and deletion policies, including any special rules for e-mail communication or even chat logs from business intelligence collaboration software. IT staff as a rule enjoy process and documentation, which can prove invaluable when a judge is asking detailed questions about steps taken during e-discovery.

Legal should work with IT from the beginning to set standards and also rely on their technical experience for tasks such as de-duplicating or retrieving deleted files. Some larger legal teams might even place their own IT staff person who has legal training into the larger IT department to form a fully integrated team.

IT must understand that all data can potentially be evidence and their technical processes need to provide 100% backup for all critical data. The duty to preserve this evidence, as in any litigation, is a critical responsibility and special steps and procedures must be in place to ensure that this data/evidence, is not inadvertently deleted or

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destroyed, and instead is preserved in accordance with the law. The legal team should build an understanding of the challenges faced by the IT staff and provide reasonable integration deadlines that would not be rushed, which could possibly introduce errors. Giving the IT team some context and guidelines on which documents or files to flag or store in a separate environment is vital to e-discovery and other ongoing legal matters. The IT developers should know about counsel's schedule and typical scenarios such as the time between filing of a case and the need for documents.

Current e-Discovery Software

Having an internal integrated plan in place will help in the e-discovery process, but it would not tackle all the present inefficiencies. Although more and more law firms and corporate legal departments are looking to bring the e-discovery process in-house, the majority of firms and corporations (through firms) still use a third-party litigation support vendor for many of these tasks.

Most of these vendors have separate buckets for each step of the EDRM (*i.e.*, collection, processing, review, delivery), with data being transferred from pail to pail in turn. The piecemeal approach became the standard because software companies developed e-discovery technology as a set of individual solutions addressing the separate steps the process. Each step is unique and poses certain development challenges. In the collection phase, someone has to actually "get" all of the data from hard drives, backup tapes, mobile devices, on-premise and cloud servers, and any other electronic source. Once collected in a centralized location, ideally the data is indexed with full text search so all the documents come together in one place and are searchable. A quality solution provider will enable multiple layers of data filters that allow you to search—for example, only Microsoft Excel documents created from November 15th to January 23rd, and that include the words "commercial real estate." Once the data is filtered and placed in a review platform, attorneys and staff can look at the documents one by one and code them related to different issues. More sophisticated review applications, however, will leverage technologies to enable reviewers to quickly review the pool of relevant documents through advance features such as near-duplicate analysis, keyword algorithms, and conceptual analysis. The final stage of delivery involves sending documents to the opposing side in a readable and searchable format.

While firms and companies can find a vendor that is able to perform all of the e-discovery tasks, that vendor is still likely using a different software provider for each stage of the process. Historically, each piece was developed as its own task, without thought given to proper integration with the other steps. While each application is critical to the process, having multiple software solutions leads to errors and inefficiencies. The vendor needs to manage the data that hits several different points along a journey, and if problems arise it can be difficult to find the error in the chain.

Having several pieces of software means the vendor typically needs a half-dozen experts on staff to manage the idiosyncrasies of each interface. That leads to increased overhead for the vendor due to unnecessarily high staffing requirements. Those higher costs are passed on to the law firms and the law firm passes those costs along to the client.

The Integrated Approach

Companies, law firms and vendors can achieve much greater efficiencies by introducing a system that uses a single software method for all of the steps, from collection through delivery. Usage of a single software platform allows better flow between steps and greater overall efficiency, with much lower chances for introduced errors. Integrated and seamless e-discovery processes provide less opportunity to overlook or misplace vital data. With multiple systems you have a series of importing and exporting tasks that can introduce errors or move data to the wrongly coded category. With a unified system you are confident the data can always be found as there is no "weak link" where data could be stuck in a different tool. Greater efficiencies come from not having to backtrack or perform in-depth sleuthing to locate

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that one missing file that could prove the tipping point for the case.

The integrated approach also offers substantial cost benefits above the piecemeal model. Choosing a vendor that runs five types of disconnected software requires covering five sets of costs for related licenses and training. The sum of these costs quickly becomes greater than the potential reward of actually bringing a strong case to trial and avoiding costly settlements. While the integrated approach pays dividends when implemented correctly, the results are always dependent on the quality of the solution provider. Just because they have a unified software approach, they still need the knowledge to run each step. Providers that have excelled in the collection of e-discovery data for many years that then quickly develop and introduce a review and filtering platform, need to be able to demonstrate the quality of their processes to deliver the total solution, not simply excel at one piece.

Putting it Together

E-discovery implemented and performed in a more integrated setting will remain complex and require the help of IT personnel regardless of how user-friendly it might become. Best practices—including inter-department collaboration and choosing an integrated vendor—will boost efficiencies and related costs and allow a sharper focus on research and litigation. While companies with an integrated and less costly e-discovery process would not take every case to trial, they do have more leeway to explore options and pursue stronger cases farther down the line to reach verdicts in their favor.

The State of Engagement Between U.S. Corporations and Shareholders

BY MARC GOLDSTEIN

The following article is from a study conducted by Institutional Shareholder Services (ISS) for the Investor Responsibility Research Center Institute (IRRC Institute). Contact: marc.goldstein@issgovernance.com.

The past several years have witnessed a significant increase in the frequency and scope of engagement between investors and issuers. Previously, "routine" communication generally referred to quarterly discussions about earnings and corporate strategy which occurred in company-designed forums such as conference calls and analyst meetings. Today, for many investors and issuers, it has become a year-round exercise involving dialogue on topics such as executive compensation, boardroom independence, and sustainability which take place in a variety of media, from conference calls and meetings to e-mails, public announcements, telephone calls and regulatory filings.

The growing tendency of issuers and investors to engage has been fueled by a number of developments. Investors, burned by scandals at companies such as Enron and WorldCom and more recently by the collapse of major financial services firms, are more sensitive to risks at their portfolio companies and less willing simply to trust boards to oversee management and leave it at that. Investors are demanding higher levels of independence and accountability in the boardroom, and remuneration programs that better align the interests of executives with those of shareholders. Shareholder proposals calling for greater accountability, such as those seeking annually elected boards and majority voting standards in director elec-

tions, typically receive strong levels of support from institutional investors, and now receive majority support on average, even counting the votes of retail investors. Directors who are perceived to act in a manner contrary to shareholders' best interests can expect to receive higher levels of opposition at the ballot box. Issuers, keenly aware of these trends, have greater incentives to engage proactively with investors.

A more investor friendly regulatory environment has also fueled increasing levels of engagement. Enhanced disclosure requirements have provided shareholders with greater visibility into company financials, potential conflicts of interest involving officers and directors, and compensation practices. This has facilitated peer comparisons and prompted shareholders to pursue additional information where they have questions or to push for change when they view the status quo to be unacceptable. Additionally, the Wall Street Reform and Consumer Protection Act, more commonly known as the Dodd Frank Act, has directed the Securities and Exchange Commission (SEC) to require public companies to allow shareholders a nonbinding vote on executive compensation (extending a mandate already applicable to companies participating in the U.S. Treasury's Troubled Asset Relief Program). Out of more than 700 "say on pay" votes through mid February 2011, five U.S. issuers failed to receive majority support for such resolutions, resulting at the very least in unwanted publicity. Experience in other markets that have "say on pay" votes, such as the United Kingdom and Australia, suggests that issuers likely will reach out to shareholders to discuss their compensation practices prior to such votes rather than face the embarrassment of significant shareholder opposition. Lastly, the New York Stock Exchange's amendment of Rule 452 to prohibit discretionary broker voting in uncontested director elections ended a practice that likely helped to inflate support for management nominees. This change has had the effect of making shareholder votes more consequential.

Issuers, too, are realizing the benefits of engaging with shareholders. Those who keep a finger on the pulse of shareholders can identify potential concerns early and address them before they reach a boiling point, thereby minimizing the prospect of contentious activity. When confronted with a contentious situation, an informed issuer can frame the debate and reach its investor base more effectively. Further, issuers that work constructively with investors can build trust and goodwill and gain advocates in the investor community. Finally, investors have different points of view about issues facing companies; some focus on capital structure, others on sustainability, etc. Some companies have found that listening to those points of view occasionally serves as an early warning system for corporate managements.

It should be understood that issuer/investor engagement is a continuously evolving process and that the level and results of engagement vary across firms and investors. The interests of issuers and investors can and do differ from time to time and conflict is inevitable. Moreover, neither all investors nor all issuers are of a single mind on most issues, so a scenario in which all parties will successfully achieve their objectives is unlikely. However, engagement can be a powerful tool for investors and issuers alike in addressing the intrinsic conflicts between the two, potentially enhancing long term value at less cost. This article, based on a study conducted by Institutional Shareholder Services (ISS) for the Investor Responsibility Research Center Institute (IRRC Institute), illuminates the current landscape of U.S. engagement and how it is evolving, including the extent of engagement, issues involved, and measures of success.

Highlights of the Study

At a time when engagement is front and center in the public debate about corporate America, this study provides the first ever benchmarking of the level of engagement between investors and public corporations (issuers) in the United States. As evidenced by the provisions of the Dodd Frank legislation, various SEC rule makings and the lawsuits contesting them, engagement has emerged as a central governance process for public companies in America. Despite that fact, there has never been a comprehensive picture of investor/corporate engagement and thus no consensus definition

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of engagement. This study attempts to rectify that lack. It surveyed 335 issuers of stock and 161 investors, including both asset owners (*e.g.* pension funds, trusts, etc.) and asset managers.

The study reveals both consensus and dissonance. There is broad consensus that engagement between issuers and investors is common and increasing both in terms of frequency and subject areas; that engagement is expanding beyond financial and strategic issues and "traditional" governance topics to include more environmental and social issues; that issues related to executive compensation remain atop the agenda; and that engagement is evolving as increasingly sophisticated investors demand more detailed information on all of these topics. Yet engagement also means different things to different people: While some use the term to refer to a campaign to persuade a company to change its behavior, others (particularly issuers themselves) classify routine conversations with investors about financial results as engagement as well. The study also reveals some distinct differences between investors and issuers in terms of the time frame of engagements and the definition of a successful engagement,

Highlights of the study include:

- The level of engagement between issuers and investors is high. Approximately 87% of issuers, 70% of asset managers, and 62% of asset owners reported at least one engagement in the past year.

- The level of engagement is increasing. Approximately 53% of asset owners, 64% of asset managers, and 50% of issuers said they are engaging more. Virtually none of the investors and only 6% of issuers responded that engagement is decreasing.

- Amongst investors, engagement is either a priority or a nonevent. A biomodal (or "barbell") distribution was evident, with 28% of asset owners and 34% of asset managers reporting engagements with more than 10 companies. On the other hand, about 45% of asset owners and 43% of asset managers indicated they did not initiate any engagement activity whatsoever.

- Despite the headlines that result from high profile conflicts between issuers and investors, the vast majority of engagements between issuers and investors are never made public. About 80% of issuers said most engagements remain private, as did 72% of asset owners and 62% of asset managers.

- Asset owners, asset investors, and issuers do not always agree on what constitutes "successful" engagement. While all three groups believed constructive dialogue on a specific issue was a success, issuers were materially more likely than investors to think that establishment of a contentious dialogue was a success. An even more dramatic difference was that about three-quarters of both asset managers and asset owners defined either additional corporate disclosures and/or changes in policies as a "success" while only about one-third of issuers agreed.

- Engagement is most likely to lead to concrete change by issuers in areas where shareholders are broadly in agreement, such as declassification of the board of directors or the elimination of poor pay practices, than in areas where shareholders' views diverge, such as the need for an independent board chair.

The study also revealed that issuers' greater willingness to be satisfied with the mere establishment of a dialogue has led them to report greater levels of success. While a majority of investors (approximately 56%) report that their engagement efforts in the past year were "sometimes successful," and only about 40% of investors claimed that such efforts were "always" or "usually" successful, roughly 80% of issuers responded that their efforts were "always successful" or "usually successful." A majority of asset managers say that the three year trend is toward their engagement activities becoming more constructive or successful, while majorities of both asset owners and issuers reported that the success of their engagements was about the same as three years earlier.

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There is a marked discrepancy in the perceived duration of engagements. Both investors and issuers report that the length of an engagement can certainly vary depending on the nature of the issue. However, a majority of both asset owners and managers indicated that an engagement typically lasts more than a month. In stark contrast, a majority of the issuer respondents indicated that engagements typically last a week or less.

The most common impediments to engagement appear to be resource related: around half of issuers and three fourths of institutions report that time is the most common impediment to engagement, while staffing considerations rank second for investors. In addition, nearly 30% of issuers and 26% of institutions report that philosophical considerations are impediments.

Study Methodology

The study included an online survey of approximately 161 institutional investors and 335 issuers based in the United States, open from March to May 2010, and in depth follow up telephone interviews with 21 investors and 22 issuers, conducted in August and September, 2010. Investors were asked to categorize themselves as either asset owners or asset managers, in order to see if the two groups differ in their approach to engagement; for example because many pension funds and other asset owners entrust engagement to their outside fund managers, or because collaboration is more difficult among asset managers, who compete with their fellow managers, than among asset owners, who generally do not compete with fellow asset owners.

On the investor side, survey respondents included mutual funds, hedge funds, asset management firms, public employee, and multiemployer pension funds, and faith based and other socially responsible investment funds. Respondents were asked to categorize the size of their assets owned or assets under management. Issuer respondents were similarly categorized by market capitalization, and included companies in a wide variety of sectors.

For each respondent, the level of engagement was assessed in terms of subject matter, frequency, participants, measurements of success, and impediments. In addition, the study evaluated how the volume and the success of engagement have changed over time and are likely to change in the future. The survey defined "engagement" broadly, as "direct contact between a shareowner and an issuer (including a board member)," allowing each respondent some flexibility to define the term as he or she saw fit.

To encourage candid responses, interview participants were promised anonymity. Accordingly, even where interviewees are quoted directly, they are not identified by name or by the name of their organization.

Engagement Logistics

Engagement Resources

A review of the survey data shows a correlation between the size of an issuer or institutional investor (measured by market capitalization or assets, respectively) and the number of people involved in engagement activities. However, a majority of all respondents answered that they had between two and five people involved in engagement. The only category of respondents for whom "2 to 5" was not the most common response was large asset managers (more than $10 billion in assets under management (AUM)), who were more likely to say that they had more than 10 staffers working on engagement. Only 5% of respondents (12.5% of investors) stated that they had no employees working on engagement. This could mean either that these respondents do not engage; or that they interpreted the question to refer to staff members *solely* dedicated to engagement. Asset owners were the group most likely to say that they have no staff involved in engagement, which suggests that some asset owners effectively outsource engagement, along with portfolio management and proxy voting, to outside fund managers.

Although the survey captured the current engagement landscape, the economic downturn may have forced many institutions to operate with smaller staffs and reduced budgets; as discussed below in the section on "*Impediments to Engagement,*" 65% of asset owners and 51% of

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asset managers listed staffing considerations as a significant obstacle to engagement.

Collaboration in Engagement

Investors were also asked in the survey how often their organization engages alone, versus collectively with other institutions. Asset managers were somewhat more likely to say that they typically engage alone: 19 asset managers said they sometimes or always involve others in the engagement process, while 24 said they typically engage alone. Eighteen asset managers said they sometimes or always coordinate engagement with others, while 21 replied "typically alone." Asset owners, however, were more likely to engage collectively: 19 asset owners said they sometimes or always involve others in the engagement process, while only 10 typically engage alone. Likewise, 19 asset owners said they sometimes or always coordinate engagement with others, while seven replied "typically alone." Part of this discrepancy between owners and managers may simply be a matter of asset managers competing with each other in a way that pension funds or other asset owners seldom do. Another explanation may be that asset managers, who are more likely to show up on a company's shareholder register than beneficial owners, are wary of triggering restrictions on "acting in concert."

On a related matter, we found some variation among investors on the matter of how often engagements were made public, though large majorities of owners and managers agreed that most engagements remain private. Issuers were even less likely to make their engagements public. (*See Table.*)

One public employee pension fund reported that its typical engagement is governed by state law, and requires regular reporting to the legislature. On the other hand, another such fund noted that public document disclosure had caused some engagement to become public, but stressed that their preference was for "quiet diplomacy," which they felt was also appreciated by the issuers with which they engage. Among issuers, answers varied in part depending on how the respondent defined the terms. One company which responded that none of its engagements with specific investors had become public admitted that its analyst conferences were Web cast; either it did not consider such webcasts to be "public," or perhaps did not consider them to be "engagement." Other issuers cited such conferences, and earnings calls, as examples of public disclosure. No issuer volunteered a preference for "quiet diplomacy" over public engagement, but during the interviews several companies did express frustration over the fact that shareholders will sometimes file a proxy proposal without first picking up the telephone.

Investors with an "activist" orientation—whether socially responsible investment funds, labor-affiliated groups or hedge funds—may sometimes have incentives to publicize their engagement with issuers, either to bring attention to a cause (and be able to take credit for any changes that companies make), or to help persuade other investors to support a shareholder proposal or a dissident candidate for the board. Conversely, many investors shun the spotlight, either to avoid criticism of their own influence, or because they think that private engagement is more effective. Issuers, for their part, may be willing to publicize engagement on financial results or M&A trans-

Have Your Engagements Been Made Public?

Respondent	None Have Become Public	Not Typically Public	Less than 50% Made Public	Most are Made Public	Total # of Responses
Asset Owners	13.8%	41.4%	17.2%	27.6%	29
Asset Mgrs.	26.2%	19.0%	16.7%	38.1%	42
Issuers	30.2%	42.8%	6.9%	20.1%	159

actions, but often stand to lose, from a public relations perspective, from disclosure of engagement over perceived defects in their governance or their labor or environmental record. In some cases, issuers may want to publicize their corporate governance reforms, but prefer to have investors think these were undertaken at the board's initiative, rather than under pressure from activist shareholders.

Impediments to Engagement

For both asset owners and asset managers, the most significant obstacles to engagement are related to resources. As noted above, among survey respondents, 65% of asset owners and 51% of asset managers listed staffing considerations as a significant impediment to engagement. About 68% of asset owners and 79% of asset managers listed "time considerations"—which obviously correlate with staff levels—as a major impediment. Public employee pension funds have been under particular pressure recently, as their budgets are set by often cash strapped states, counties, and cities.

One asset owner noted that travel was the largest concern when engaging overseas companies. As with issuers, no investor specifically pointed to language or cultural barriers, a result which the interview responses suggest is due to two factors. First, smaller investors are simply less likely to engage with overseas issuers; second, larger asset management firms—whose overseas holdings are more extensive—engage those companies through their overseas offices, or with the assistance of brokers who provide interpreters and other logistical support.

Time is the largest impediment for all respondents. But while 50% of issuers cited that obstacle, they indicated staffing considerations less often than regulatory concerns (such as Regulation FD), which were flagged as a hurdle to engagement by 43% of issuer respondents. However, one asset manager asserted that Reg. FD concerns were more of an excuse cited by issuers than an actual obstacle; and one issuer noted that Reg. FD is not an obstacle to engagement on governance matters. In June 2010, after the survey had closed, the SEC issued guidance on this topic, explicitly stating that Reg. FD does not prohibit directors from speaking privately with a shareholder or group of shareholders, and suggesting steps that companies can take to avoid violations of Reg. FD's prohibition on selective disclosure, such as preclearing discussion topics with the shareholder, having company counsel participate in the meeting, or getting the shareholder to expressly agree to maintain the disclosed information in confidence.

The SEC, as part of its recent concept release on "proxy plumbing" issues, has suggested it may reexamine the distinction between "objecting" and "non objecting" beneficial owners—largely in response to issuer complaints about the difficulty of communicating with objecting beneficial owners (OBOs). However, only 21% of issuers responding to the survey cited "insufficient information (*e.g.*, OBOs)" as an obstacle to engagement. This suggests that the SEC may want to exercise caution before making radical changes to the current system.

"Philosophical considerations" were cited as an impediment by 29% of issuers—and by 32% of asset owners. During the interviews, some issuers expressed frustration at shareholder proponents who submit proposals without first contacting the company, or who submit the same proposal to numerous companies regardless of differences among them. Other respondents offered reasons that could easily be classified as "philosophical," such as "unreasonable stockholder demands" and "entrenched management." However, only a small number of issuers or investors were willing to go so far as to accuse their counterparts of being generally unwilling to engage.

In the comments to the survey responses, four issuers and two asset managers noted that simply finding the right point of contact was sometimes an obstacle to engagement. Other hurdles include SEC rules governing the right to file a shareholder proposal (noted by two asset managers); the travel needed to engage overseas companies (raised by an asset owner); lack of clarity on a shareholder's ultimate objective (mentioned by an issuer); and a "lack of fundamental analysis on the issues by [shareholder] proponents" (cited by an issuer).

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Aside from these general impediments to engagement, a number of investors expressed frustration about an inability to engage with members of the board. There appears to be a widespread perception that issuer staff often acts as gatekeeper and that (in the words of an investment fund partner) "CEOs usually want to keep issues away from their bosses." One asset manager diplomatically referred to board access as a "work in progress," noting that few companies were willing to put their directors in front of shareholders. Another asset manager complained that companies seem to feel they have done enough merely by making directors available, even if nothing concrete comes out of the meeting. Yet these frustrations were not universally shared, and some investors—particularly large ones—are satisfied with their access to boards. One large asset manager noted that it "picks [its] spots"—generally seeking board access only where it holds a large stake that it plans to maintain for some time. A large public employee fund noted that its engagement with directors is facilitated by the fact that it has the resources to travel to visit those directors.

On the other hand, a small asset management firm said it, too, was satisfied with board access, because if it gets no response initially, it will threaten a proxy contest. Meanwhile, a number of issuers indicated during the interview process that they seldom or never received requests from shareholders to engage with directors.

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