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DELAWARE SUPREME COURT REAFFIRMS DISGORGEMENT AS INSIDER TRADING REMEDY

Disavowing recent Court of Chancery precedent, the Supreme Court of Delaware has held disgorgement to be an insider trading remedy, even where the corporation itself was not harmed. *Kahn v. Kohlberg Kravis Roberts & Co., L.P.*, No. 436, 2010 (June 20, 2011). *Kahn* rejected two prior Chancery Court opinions narrowly construing *Brophy*, a 1949 Chancery Court decision, and remanded the case before it for a determination of whether dismissal was appropriate for reasons other than a lack of corporate injury. As a result, *Brophy*, which was thought to be of limited vitality, has been strongly reaffirmed. It is now clear that derivative suits alleging insider trading may proceed even in the absence of any injury to the corporation itself.

BACKGROUND

Shareholders sued Primedia, Inc. ("Primedia"), its directors, and Kolberg Kravis Roberts & Co., L.P. ("KKR"), Primedia's controlling shareholder, alleging breaches of fiduciary duty relating to KKR's purchase of Primedia preferred stock based on material, nonpublic information. KKR was alleged to have purchased Primedia shares after learning the company intended to sell one of its largest assets.

The Primedia Board then appointed a Special Litigation Committee consisting of two independent directors elected after the events at issue. The Special Litigation Committee reviewed 140,000 pages of documents, conducted more than 20 interviews, and held more than 20 formal meetings. Relying on consultant analyses, the Special Litigation Committee issued a lengthy report concluding that any nonpublic information received by KKR was immaterial because it did not affect the market price when disclosed and that KKR did not intend to profit wrongfully from the nonpublic information. The report also found that the stock purchases were not motivated by KKR's self-interest and that *scienter* was lacking. The Special Litigation Committee then moved to

dismiss the lawsuit. Vice Chancellor J. Travis Laster, applying the two-prong *Zapata* test, granted the motion. *In re Primedia Inc. Derivative Litig.*, C.A. No. 1808 (Del. Ch. Jun. 14, 2010) (Transcript).

Under *Zapata*, a court must first determine whether a special committee was acting independently and in good faith. If it finds that a committee acted properly, a court may then apply its own judgment to determine whether litigation would be appropriate. In an oral opinion, Vice Chancellor Laster found that the Special Litigation Committee had met its burden under the first *Zapata* prong. Addressing *Zapata*'s discretionary second prong, Vice Chancellor Laster relied on his 2010 decision in *Pfeiffer v. Toll*, 989 A.2d 683 (Del. Ch. 2010), holding that a plaintiff must show that a corporation suffered actual harm before proceeding with a *Brophy* claim. Because no such injury was alleged in *Primedia*, the Chancery Court dismissed the case.

Pfeiffer had narrowly limited *Brophy v. Cities Service Co.*, 70 A.2d 5 (Del. Ch. 1949). Although *Pfeiffer* apparently construed *Brophy* as not having addressed this issue, the Supreme Court found that the 1949 decision in fact held that public policy required an insider to disgorge profits obtained through the use of confidential corporate information, even if the corporation did not suffer a loss as a result of that insider trading. In his 2010 *Pfeiffer* decision, however, Vice Chancellor Laster, building on Vice Chancellor Leo E. Strine, Jr.'s decisions in *Guttman v. Huang*, 823A.2d 492, 499-507 (Del. Ch. 2003), *In re Oracle Corp Derivative Litigation*, 867 A.2d 904 (Del. Ch. 2004), *aff'd*, 872 A.2d 960 (Del. Ch. 2005), and *In re American International Group Inc.*, 965 A.2d 763, 813 (Del. Ch. 2009), held that because the purpose of a *Brophy* claim is to remedy harm to the corporation, the disgorgement remedy must be limited to instances in which inside information was used to injure the company, for example to usurp a corporate opportunity or to compete with the corporation.

THE *KAHN* DECISION

The Delaware Supreme Court rejected *Pfeiffer*'s, and thus *Primedia*'s, interpretation of *Brophy*, holding that a corporation does not need to suffer actual harm for there to be a viable *Brophy* claim. The Court thus held that a derivative plaintiff must show only that a fiduciary (1) possessed material, nonpublic company information, and (2) executed trades motivated by the substance of that information. *Kahn*, No. 436, 2010, at 13-14, 19.

It is notable that the Supreme Court reached its decision notwithstanding plaintiffs' impending loss of standing to prosecute the case further because Primedia had recently announced that it would be acquired and, thus, the derivative plaintiffs would not have "continuous ownership" of Primedia shares. The Court proceeded nevertheless under the exception to the mootness doctrine for "matters of public importance that are capable of repetition yet may evade review."

The Court's decision was based on the *Brophy* policy of preventing unjust enrichment due to the misuse of confidential corporate information. Vice Chancellor Laster's restriction of disgorgement to the cases in which inside information is used to usurp a corporate opportunity or to compete with the corporation, the Court held, was not consistent with the rationale underlying *Brophy* and subsequent Delaware cases, including *In re Oracle Corp. Derivative Litigation*, 867 A.2d 904 (Del. Ch. 2004), *aff'd*, 872 A.2d 960 (Del. Ch. 2005) (Order), seeking to deter trading on inside information.

Reviewing the Court of Chancery's *Zapata* analysis, the Supreme Court agreed that the Special Litigation Committee had acted in good faith and had a reasonable basis to move for dismissal. The Supreme Court was convinced by the Special Litigation Committee's lengthy and well-documented report, revealing a thorough and balanced investigation of the claims. However, the Court remanded to the Chancery Court for further analysis of the second *Zapata* prong, namely, whether issues such as materiality, *scienter*, timeliness, and indemnification required dismissal.

CONCLUSION

Pfeiffer's holding that harm must fall to the corporation under *Brophy* was in part based on a perceived need to avoid duplicative Delaware remedies by differentiating *Brophy* claims from those brought under federal securities law. By rejecting

Pfeiffer, the Delaware Supreme Court in *Kahn* signaled that claims under Delaware law for breaches of fiduciary duty will remain available to plaintiffs for insider trading claims even when there is no actual harm to the corporation because a fiduciary wrongdoer should not be unjustly enriched. In addition, *Kahn* is consistent with Vice Chancellor Laster's pre-*Pfeiffer* decision in *NACCO Industries Inc. v. Applica*, 997 A.2d 1, 23 (Del. Ch. 2009), holding that Delaware common law fraud remedies are available for misstatements in Schedule 13D filings. *Kahn* specifically noted that Delaware remedies for insider trading are not restricted by parallel remedies under the federal securities laws.

You can download a copy of the full *Kahn* opinion by clicking here.

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