

## WSGR ALERT

JANUARY 2012

# DELAWARE COURT OF CHANCERY DISMISSES AND SANCTIONS REPRESENTATIVE PLAINTIFF IN MERGER LITIGATION FOR TRADING STOCK WHILE IN POSSESSION OF NON-PUBLIC INFORMATION OBTAINED THROUGH DISCOVERY

On January 6, 2012, the Delaware Court of Chancery issued an opinion dismissing with prejudice one of the representative plaintiffs in a class action for trading stock while in possession of non-public information that the defendants had produced in discovery. The court held that such trading is unacceptable and constitutes a breach of the fiduciary obligations that representative plaintiffs have to the class. Wilson Sonsini Goodrich & Rosati is representing the defendants in this litigation.

### Background

Occam Networks, Inc., was a publicly traded Delaware corporation that announced on September 16, 2010, that it had entered into a merger agreement with Calix, Inc., another publicly traded company in the telecommunications equipment industry. The agreement provided that each share of Occam stock would be converted into the right to receive \$3.83 in cash and 0.2925 shares of Calix stock.

On October 1, 2010, several Occam shareholders, including Michael Steinhardt and two funds under his control, filed a class action complaint challenging the merger in the Delaware Court of Chancery. At that time, Mr. Steinhardt, a legendary hedge fund manager who has been described as "one of the most successful investors in the history of Wall Street," and his funds owned more than 2.8 million shares of Occam, which represented 13.5 percent of Occam's outstanding stock.

As part of these proceedings, the court entered a confidentiality order to protect the non-public information that would be exchanged in discovery. This order contained both a general requirement that non-public information produced in the action be used solely for purposes of the litigation and a specific restriction against purchasing, selling, or otherwise trading in the securities of Occam or Calix on the basis of such information.

On an expedited basis in December 2010 and early January 2011, the defendants and Occam's investment banker produced documents and testified in depositions. Both the documents and the depositions contained confidential non-public information.

Beginning on December 28, 2010, when the document productions were nearly complete, Mr. Steinhardt began short-selling Calix stock as a way to exit his Occam position. His sales continued through the closing of the merger. In total, Mr. Steinhardt and his funds sold short more than 580,000 shares of Calix. Given that the merger consideration would be a mix of cash and Calix stock, in effect Mr. Steinhardt's short sales equated to selling the Calix stock that he would receive for 2 million of his 2.8 million shares of Occam.

On January 24, 2011, the court issued a preliminary injunction delaying the stockholder vote on the merger pending certain supplemental disclosures. After those disclosures were made, the deal closed and Occam shareholders received Calix stock and

cash in exchange for their Occam shares. The case continued after the deal closed.

During discovery, the defendants learned of Mr. Steinhardt's trading. Mr. Steinhardt later admitted that at the time he decided to start short-selling Calix stock he had been receiving regular written and oral updates on the status of this case from Herbert Chen, another plaintiff who worked closely with the plaintiffs' lawyers and personally was reviewing documents and deposition testimony in the litigation. Mr. Chen knew that Mr. Steinhardt was short-selling Calix stock, and he later claimed that he advised Mr. Steinhardt to stop making these trades.

Based upon this information, the defendants filed a motion for sanctions on the basis that Delaware law prohibits plaintiff-fiduciaries from trading stock while they are in possession of non-public information they obtained in discovery.

### The Court of Chancery's Conclusions

After conducting an evidentiary hearing at which it heard the testimony of Messrs. Steinhardt and Chen, the court granted the defendants' motion for sanctions with respect to Mr. Steinhardt, but denied the motion with respect to Mr. Chen, who testified that his sale of a few thousand shares was an error. The court agreed with the defendants that "it is unacceptable for a plaintiff-fiduciary to trade on the basis of non-public information obtained through litigation." The court explained that a stockholder who files suit as

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a representative for a class “voluntarily assume[s] the role of a fiduciary for the class,” so he cannot use for his own personal advantage the non-public information he may obtain in discovery. According to the court, such conduct “undermines the integrity of the representative litigation process.”

As a sanction for this trading, the court dismissed Mr. Steinhardt and his funds from the case with prejudice, barred them from receiving any future recovery in the lawsuit, required them to self-report their improper trading to the Securities and Exchange Commission and disclose it in any future application to serve as lead plaintiff, and ordered them to disgorge profits of over \$530,000.

### **Implications for Other Litigation**

The Court of Chancery’s decision reaffirmed the court’s long-standing view that a plaintiff filing a complaint on behalf of a class has a fiduciary obligation to the class and may not use that position to benefit personally from information learned in the case, such as by trading stock on the basis of that information. This is particularly significant in litigation related to public company mergers. Following the announcement that a public company’s board of directors has agreed to a merger or sale of the company, the filing of a class action complaint is now almost a reflexive act, with a shareholder alleging that the deal is not in the interests of the shareholders and that disclosures concerning the deal are in some way inadequate. The court’s decision makes clear that plaintiffs who file such cases cannot trade stock as they otherwise might wish. These limitations may have their most significant impact on institutions that might otherwise want to be active traders or hedge while at the same time serving as plaintiffs.

For more information about this case or any other related litigation matter, please contact a member of Wilson Sonsini Goodrich & Rosati’s securities litigation practice.



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