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Delaware Insider:

The Slow But Sure Evolution Of *Brophy*: Delaware's Common Law Action for Insider Trading

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Many corporate practitioners both inside and outside of Delaware, at least until recently, may likely have considered a common law fiduciary duty claim for insider trading an antiquated notion with only historical significance given the federal regime of securities laws developed over the past half-century. Think again. A string of recent Delaware decisions demonstrates that the fiduciary insider trading claim – known as a "*Brophy*" claim after the 1949 case that first recognized it as a cause of action in Delaware – is anything but antiquated and warrants attention by not only traditional corporate insiders (i.e., directors and officers), but also significant stockholders with board representation or observation rights. Indeed, in certain circumstances, stockholder plaintiffs may find a higher likelihood of success asserting a fiduciary insider trading claim under Delaware law as opposed to asserting a claim arising from the same acts under federal securities laws. Given the Delaware Supreme Court's recent clarification that disgorgement of any gain realized by the improper trades at issue is an available remedy, the incentives for plaintiffs bringing such claims have only increased.

The Court of Chancery first recognized a fiduciary duty claim for insider trading in a case called *Brophy v. Cities Service Co.*, 70 A.2d 5 (Del. Ch. 1949). In that case, a stockholder brought a derivative action against the directors of Cities Service Company and Thomas Kennedy, described as a "confidential secretary" to a director and officer of the company. The plaintiff stockholder alleged that, during the course of his employment, Kennedy had obtained knowledge of non-public information regarding the company's plans to buy back its own shares. The plaintiff stockholder also alleged that Kennedy took advantage of that non-public information and bought a large block of the company's shares in the market. After the corporation's planned purchases raised the market price of its stock, Kennedy resold his recently acquired shares to the corporation at a profit. Kennedy moved to dismiss the complaint, contending that no cause of action could be stated against him because he was not a fiduciary to the corporation and the corporation had not suffered any actual harm.

The court disagreed and held the complaint stated a valid derivative claim for breach of the fiduciary duty of loyalty against Kennedy based upon his alleged purchase and sale of company stock. The court's holding was based on the Delaware public policy, announced most famously 10 years earlier by the Delaware Supreme Court in the seminal case of *Guth v. Loft*, that "corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests." Thus, despite not being an officer or director of the corporation, the court found Kennedy occupied a position of trust and confidence within the corporation and deemed his position to be analogous to that of a fiduciary. With respect to Kennedy's argument that the corporation had suffered no harm, the court held that as a matter of equity, where the claim is that a fiduciary abused a position of trust for personal gain, actual harm to the corporation is not required.

In the years following the Court of Chancery's recognition of a *Brophy* claim, the cause of action was infrequently asserted. The Delaware decisions in that time period addressing *Brophy* claims established that to succeed on such a claim, a plaintiff must show that (1) the corporate fiduciary was in possession of material, nonpublic company information, and (2) the corporate fiduciary used that information in making trades and was motivated, in whole or in part, by the substance of that information. These decisions also established that as a derivative claim belonging to the corporation, in order for a stockholder plaintiff to maintain it, the complaint must allege with specificity that a demand that the corporation's board of directors assert the claim on the corporation's behalf was futile and therefore excused from the demand requirement of Court of Chancery Rule 23.1. Satisfying this test requires a stockholder plaintiff to plead particularized allegations creating a "reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested judgment in responding to a demand."

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The years following the *Brophy* decision also saw the growth of a comprehensive body of federal law addressing insider trading including provisions for criminal penalties and private rights of action seeking damages such as disgorgement of profits realized from improper insider trades. The theory that the federal securities laws had rendered *Brophy* claims a dispensable aspect of Delaware corporate law was commonly held among Delaware practitioners and was ultimately raised by the defendants in *In re Oracle Corporation Derivative Litigation*, 867 A.2d 904 (Del. Ch. 2004), a lawsuit asserting *Brophy* claims against Lawrence Ellison and another officer of Oracle, Inc. In *Oracle*, plaintiffs alleged that Mr. Ellison and Oracle's CFO, Jeffrey Henley, sold large amounts of Oracle stock in January 2001 while in possession of non-public information suggesting that Oracle would be unable to meet its publicly-announced revenue and earnings projections for the fiscal quarter ending in February of that year. Among other things, the defendants argued that given the emergence of the comprehensive federal securities law regime since *Brophy* was decided, *Brophy* claims were duplicative and unnecessary and should no longer be part of Delaware's corporate law. Such common law claims, the defendants argued, overlapped with federal securities laws and drove up costs for defending duplicative litigation relating to the same underlying conduct. However, because the court determined that the defendants were entitled to summary judgment on the merits of the *Brophy* claim, it declined to rule on the "important policy question" of whether *Brophy* was an outdated precedent that ought to be abandoned.

That important policy question was raised again and decided in *Pfeiffer v. Toll*, 989 A.2d 683 (Del. Ch. 2010). In *Pfeiffer*, a plaintiff stockholder brought a derivative action asserting *Brophy* claims against the directors of Toll Brothers, Inc., to recover damages for alleged insider trading. The stockholder alleged the defendants sold significant amounts of Toll Brothers stock while in possession of material, non-public information about the housing bubble's negative impact on Toll Brothers' future prospects. The defendant directors and the corporation moved to dismiss the complaint on the grounds that it did not adequately allege a *Brophy* claim and that, even if it did, *Brophy* was no longer good law in light of seemingly duplicative federal securities laws that addressed insider trading.

The court denied the motion to dismiss the *Brophy* claim, finding that the complaint adequately pleaded demand futility given that a majority of the board were defendants in a companion federal securities action arising out of the same alleged wrongdoing that had survived a motion to dismiss. The court also found that the complaint adequately alleged, as judged under the plaintiff-friendly Rule 12(b)(6) standard, that Toll Brothers' directors and officers, including several outside directors, possessed material non-public information with respect to the company's core metrics for revenue and profitability, which showed that the company would not meet their publicly announced projections. Finally, the court found that the defendants acted with the requisite scienter when they sold their company stock on the basis of that information for their own benefit.

Turning to the argument that *Brophy* was longer good law because it seemingly operated in duplication with federal securities laws, the court opined that *Brophy* remained good law given Delaware's view, going back at least to the Delaware Supreme Court's seminal 1939 decision in *Guth v. Loft*, that corporate fiduciaries may not profit from their positions of trust. Rather than conflict with federal securities laws, the *Pfeiffer* court held that the continued existence and recognition of a *Brophy* claim "is consistent with – and supportive of – the federal securities regime." This was so, according to the court, because a *Brophy* claim remedies harm to the corporation, whereas federal securities laws are designed to remedy harm to stockholders and, more specifically, stock market participants.

But at the same time as it confirmed Delaware's continued recognition of a *Brophy* claim, the *Pfeiffer* court greatly limited its bite, holding that except in very narrow circumstances, disgorgement of the wrongdoer's gains was not an available remedy and that damages would be limited to measurable harm to the corporation itself. The court gave as examples of damages recoverable pursuant to a *Brophy* claim, costs and expenses relating to regulatory, criminal, and civil proceedings initiated as a result of the fiduciary's misconduct. In *Pfeiffer* itself, the plaintiffs were seeking damages to the company resulting from the companion federal securities lawsuit.

Pfeiffer's near-elimination of disgorgement as a remedy pursuant to a *Brophy* claim was soundly rejected by the Delaware Supreme Court in *Kahn v. Kolberg Kravis Roberts & Co., L.P.*, 23 A.3d 831 (Del. 2011). In *Kahn*, the state supreme court considered the appeal of the Court of Chancery's decision regarding the viability of a *Brophy* claim against defendant Kolberg Kravis and Roberts & Co., L.P. (KKR). KKR was the majority stockholder of nominal defendant, Primedia, Inc. The Primedia stockholder plaintiffs alleged, among other things, that KKR obtained non-public company information through its board designees and used that information to purchase company preferred stock it later sold at a substantial profit. During the pendency of the case in the Court of Chancery, Primedia formed a special litigation committee that investigated and ultimately sought the dismissal of the plaintiffs' claims, including the *Brophy* claim. In the proceedings below, the Court of Chancery found that while the *Brophy* claim stated a valid cause of action, the potential damages available to the company – which would not include disgorgement per *Pfeiffer* – were insubstantial and the special litigation committee was thus justified in seeking to dismiss this claim rather than recommending that the company pursue it.

Plaintiffs appealed the *Primedia* court's decision to the Delaware Supreme Court. While reciting with approval the *Pfeiffer* court's holding that *Brophy* remained good law, the Delaware Supreme Court, relying on *Guth*, overruled *Pfeiffer*'s holding that disgorgement was generally not a permis-

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sible remedy in the *Brophy* context except in limited circumstances. Rather, the Supreme Court found "no reasonable policy ground to restrict the scope of disgorgement remedy in *Brophy* cases – irrespective of arguably parallel remedies grounded in federal securities laws." The Supreme Court also took the occasion to overrule *Pfeiffer*'s holding that a *Brophy* claim exists to remedy harm to the corporation and specifically held that harm to the corporation is not a required element to pleading a *Brophy* claim.

In a later, related proceeding, *In re Primedia, Inc. Shareholders Litigation*, 67 A.3d 455 (Del. Ch. 2013), the Court of Chancery again considered the merits of the *Brophy* claim against KKR. The court again found that the *Brophy* claim was a viable cause of action and would survive a motion to dismiss. The court also explained that, even though the value of the claim was no longer relevant to its analysis, had it considered full disgorgement of KKR's gains as a potential remedy, it would have denied the special litigation committee's motion to dismiss as the potential recovery would have risen from approximately $1.5 million to $150 million.

Conclusion and Key Takeaways

Over 60 years after the *Brophy* decision, it appears that the two key areas of doubt concerning the viability and usefulness of these types of fiduciary duty claims have finally been definitively resolved. It is now clear that *Brophy* claims may be asserted under Delaware law without regard to a potential conflict with federal securities laws addressing the same underlying conduct. With the Delaware Supreme Court's endorsement of disgorgement as a potential remedy, the practical barriers that may once have prevented plaintiffs from asserting such claims have been lifted. It remains to be seen whether these clarifications result in the filing of more *Brophy* claims in the coming years.

The receipt of material non-public corporate information by directors, even outside directors as evidenced by the *Pfeiffer* case, is all but inevitable. Such traditional fiduciaries should thus take heed that to the extent they hold and trade in the securities of the companies they serve, they must not only navigate the applicable federal securities laws, but also consider whether their activities may also subject them to liability to the company under Delaware law and take appropriate precautions. Significant stockholders of Delaware corporations with board designees or observation rights must also take the potential liabilities imposed under *Brophy* into consideration when making transactions regarding the company's stock. Even non-controlling stockholders may be considered fiduciaries for the purposes of a *Brophy* claim given their sponsorship of directors on the company's board who are privy to material non-public information.

The incentives of stockholder plaintiffs and their counsel to bring *Brophy* claims would seem to have increased with the confirmation that disgorgement of all gain by the alleged wrongdoer is a potential measure of damages. And, not only are the potential awards higher, but in certain circumstances, successfully pleading a *Brophy* claim will be less of a burden than a federal securities claim which is subject to the heightened pleading standards imposed by PSLRA. Though *Brophy* claims are generally subject to the heightened standard of pleading demand futility, that burden may be overcome if there is reason to question the independence of a majority of the company's board. It is possible to make such a showing independently of the merits of the *Brophy* claim itself. Once demand futility has been established, *Brophy* claims are subject to the plaintiff-friendly Rule 12(b)(6) standard.

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