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# Simmonds v. Credit Suisse Securities: Applying Delaware's Demand Requirement to Section 16(b)

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## *Simmonds v. Credit Suisse Securities: Applying Delaware's Demand Requirement to Section 16(b)*

### I. INTRODUCTION

When the share price of LinkedIn's initial public offering (IPO) jumped 109% in the first day of trading,<sup>1</sup> some wondered whether the event was the start of another tech bubble<sup>2</sup> or "hot issue" market where a series of IPOs witness dramatic price increases in the first month of trading.<sup>3</sup> Since the 1950s, there have been four hot issue markets,<sup>4</sup> including the most recent during the late-1990s tech boom, where almost 200 IPOs doubled on the first day of trading.<sup>5</sup> The same question has accompanied each of these hot issue markets: in light of the seemingly exorbitant fees paid to sophisticated investment banks for an optimal IPO price,<sup>6</sup> were the underwriting banks really unable to even closely predict the market price of the IPOs, or were issuers intentionally leaving vast amounts of capital on the table?<sup>7</sup>

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1. Stu Woo et al., *LinkedIn IPO Soars, Feeding Web Boom*, WALL ST. J., May 20, 2011, at A1.

2. See, e.g., Yuki Noguchi, *In LinkedIn IPO, Hints Of Another Tech Bubble?*, NPR.ORG (May 26, 2011), <http://www.npr.org/2011/05/26/136655334/in-linkedin-ipo-hints-of-another-tech-bubble>.

3. Roger G. Ibbotson & Jeffrey F. Jaffe, "Hot Issue" Markets, 30 J. FIN. 1027, 1027 (1975) (defining hot issue markets "as periods in which the average first month performance (or aftermarket performance) of new issues is abnormally high"); see also *In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d 281, 300 (S.D.N.Y. 2003).

4. *In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 300.

5. Jay R. Ritter, *Big IPO Runups of 1975-2011*, U. FLA. (May 20, 2011), [http://bear.warrington.ufl.edu/ritter/Runup7510%20\(2\).pdf](http://bear.warrington.ufl.edu/ritter/Runup7510%20(2).pdf). In the twenty-four years before 1999, only thirty-nine IPOs doubled on the first day of trading. *Id.*

6. For example, LinkedIn IPO fees totaled over \$20 million. Brett Philbin, *Fee Bonanza! Wall Street Rakes in Millions from LinkedIn IPO*, WALL ST. J. DEAL BLOG (May 19, 2011, 5:09 PM), <http://blogs.wsj.com/deals/2011/05/19/fee-bonanza-wall-street-rakes-in-millions-from-linkedin-ipo/>.

7. A number of theories have been proposed for the "underpricing phenomenon." Roger G. Ibbotson & Jay R. Ritter, *Initial Public Offerings*, in 9 HANDBOOKS IN OPERATIONS RESEARCH AND MANAGEMENT 993, 995-1001 (R. Jarrow et al. eds., 1995) (outlining, among others, the "winner's curse hypothesis," the "cascades hypothesis," the "investment banker's monopsony hypothesis," the "lawsuit avoidance hypothesis," and the "signaling hypothesis"); see also Stephen J. Choi & A. C. Pritchard, *Should Issuers Be on the Hook for Laddering? An Empirical Analysis of the IPO Market Manipulation Litigation*, 73 U. CIN. L.

Almost inevitably, some investors have suspected foul play and have alleged fraud under Rule 10b-5 of the Securities Exchange Act of 1934 (Exchange Act).<sup>8</sup> In *Simmonds v. Credit Suisse Securities*, however, the plaintiff alleged a new theory of liability and sued the underwriting banks under Section 16(b) of the Exchange Act to recover profits on behalf of the issuers.<sup>9</sup> In denying the plaintiff's standing to make a Section 16(b) claim, the Ninth Circuit used Delaware corporate law to conclude that the plaintiff's pre-suit demand was insufficient, or in other words, that the plaintiff failed to adequately request issuer action before filing her own suit on the issuer's behalf.<sup>10</sup>

This Note argues that due to the conflicting purposes of Delaware's demand requirement and Section 16(b), the Ninth Circuit should not have dismissed the suit using Delaware demand law. More broadly, this Note argues that before courts fill the gaps of federal securities law with state corporate law, they should consider the fit between the two types of law. Doing so will prevent state law from impeding federal policy and otherwise valid securities claims and will prevent unnecessary displacement of well-functioning state law.

## II. FACTS AND PROCEDURAL HISTORY

In the most recent hot issue market of the late 1990s and early 2000, plaintiff Vanessa Simmonds, like many others, felt that the drastic first-day IPO price changes were not due to market forces but instead were the result of a scheme between the underwriters and insiders of the issuing companies to capture exponential gains from

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REV. 179, 186 (2004) ("A large price gain on the first day suggests that issuers have left substantial sums of money on the table."); Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711, 724-25 (2005) ("[T]he underpricing of IPO shares is often an intentional act designed to extract wealth for the few that receive original IPO allocations.").

8. See *In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 353.

9. *Simmonds v. Credit Suisse Sec. (USA) LLC*, 638 F.3d 1072, 1084 (9th Cir. 2011) *cert. denied*, 131 S. Ct. 3063 (2011), *and cert. granted*, 131 S. Ct. 3064 (2011). It should be noted that the Supreme Court has granted certiorari to hear an issue addressed in *Simmonds* regarding the statute of limitations requirement of Section 16(b). *Credit Suisse Sec. (USA) LLC v. Simmonds*, 131 S. Ct. 3064 (2011) (mem.); see Petition for Writ of Certiorari, *Credit Suisse Sec.*, 131 S. Ct. 3064 (No. 10-1261). This Note does not address that issue.

10. *Simmonds*, 638 F.3d at 1094.

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underpriced IPOs.<sup>11</sup> Instead of filing a traditional Rule 10b-5 claim alleging a fraudulent scheme,<sup>12</sup> however, Ms. Simmonds filed a novel derivative Section 16(b) claim, alleging that the underwriting banks of fifty-four issuing companies were liable for “short-swing profits . . . made in violation of Section 16(b).”<sup>13</sup> Specifically, Ms. Simmonds alleged the underwriters had engaged in “spinning,”<sup>14</sup> a controversial practice during the 1998-2000 hot issue market.<sup>15</sup>

Section 16(b) requires statutory insiders<sup>16</sup> to disgorge any profits made in connection with the purchase and sale of company stock occurring within a six-month period.<sup>17</sup> Although Section 16(b) requires recovered profits to be paid directly to the issuer, Section 16(b) claims can be brought in federal court by either the issuer itself or any shareholder.<sup>18</sup> Importantly, however, shareholders may only bring a Section 16(b) claim if the issuer “shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same.”<sup>19</sup> Thus, as a shareholder, Ms. Simmonds only had standing when the issuing companies themselves refused or

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11. *In re* Section 16(b) Litig., 602 F. Supp. 2d 1202, 1204 (W.D. Wash. 2009) *aff'd in part, vacated in part, rev'd in part sub nom.* Simmonds v. Credit Suisse Sec. (USA) LLC, 638 F.3d 1072 (9th Cir. 2011) *cert. denied*, 131 S. Ct. 3063 (2011), *and cert. granted*, 131 S. Ct. 3064 (2011).

12. Rule 10b-5 is the foundational securities fraud claim. *See* Matthew R. King et. al., *Securities Fraud*, 46 AM. CRIM. L. REV. 1027, 1029 (2009).

13. *In re* Section 16(b) Litig., 602 F. Supp. 2d at 1207.

14. *Id.* at 1211. “Spinning” occurs when underwriting investment banks allocate IPO shares to corporate executives in order to secure future investment banking business. Xiaoding Liu & Jay R. Ritter, *The Economic Consequences of IPO Spinning*, 23 REV. FIN. STUD. 2024, 2024–26 (2010) (analyzing the connection between spinning and IPO pricing); *see also* Sean J. Griffith, *Spinning and Underpricing: A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings*, 69 BROOK. L. REV. 583, 586–87 (2004).

15. *See* NYSE/NASD IPO ADVISORY COMMITTEE, REPORT AND RECOMMENDATIONS I (2003), *available at* <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p010373.pdf> (naming spinning as one of the “most harmful practices” that occurred during the tech boom); Randall Smith, *Long After Dotcom Bust, IPO ‘Spinning’ Rules Take Effect*, WALL ST. J. DEAL BLOG (Sept. 26, 2011, 5:27 PM), <http://blogs.wsj.com/deals/2011/09/26/long-after-dotcom-bust-ipo-spinning-rules-take-effect/>.

16. For purposes of Section 16(b), directors, officers, and those owning more than ten percent of an issuing company’s stock are considered statutory insiders. 15 U.S.C. § 78p (2006). Ms. Simmonds contended that the underwriters, as the direct or beneficial owners of more than 10 percent of the issuing companies’ stock, qualified as statutory insiders. *In re* Section 16(b) Litig., 602 F. Supp. 2d at 1207.

17. 15 U.S.C. § 78p(b) (2006).

18. *Id.*

19. *Id.*

failed to bring their own Section 16(b) claims. To comply with this requirement, Ms. Simmonds sent demand letters to the issuers' board of directors, asking them to bring Section 16(b) claims against the underwriters.<sup>20</sup> When the respective boards failed to take action, Ms. Simmonds filed a Section 16(b) claim in federal court to recover profits on behalf of the issuers.<sup>21</sup>

At the district court, both the issuers and underwriters filed motions to dismiss the suit.<sup>22</sup> The issuers specifically argued,<sup>23</sup> *inter alia*, that Ms. Simmonds lacked standing because she failed to sufficiently identify the insiders in question or to describe the legal or factual basis for her claims.<sup>24</sup> In response, Ms. Simmonds alleged that, as a mere shareholder, she was not privy to the trade or business information necessary to make a more specific factual allegation.<sup>25</sup>

In granting the issuers' motion to dismiss, and without addressing the underlying merits of her Section 16(b) claim, the district court used Delaware corporate law to outline the insufficiency of Ms. Simmonds's demand letters.<sup>26</sup> In particular, the court stated that sufficiency of demand was "governed by the law of the state of incorporation" and that because all the issuers were Delaware corporations, Delaware law would control.<sup>27</sup> Under Delaware law,<sup>28</sup> the court concluded, Ms. Simmonds had not given the issuing companies the "requisite specificity [in her demand letters] to give the directors a fair opportunity to initiate suit."<sup>29</sup> Or, to use the language of Section 16(b), the court determined that the directors of the issuing companies had not "fail[ed] or refuse[d]" to initiate suit.<sup>30</sup>

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20. *In re Section 16(b) Litig.*, 602 F. Supp. 2d at 1210.

21. *Id.*

22. *Id.* at 1208.

23. The underwriters likely did not argue the inadequacy of Ms. Simmonds's demand letters because prior courts have held that in derivative suits, only the issuers have standing to object to a shareholder's demand. *See Dreiling v. Am. Express Travel Related Serv. Co. Inc.*, 351 F. Supp. 2d 1077, 1084 (W.D. Wash. 2004), *rev'd on other grounds*, 458 F.3d 942 (9th Cir. 2006).

24. *In re Section 16(b) Litig.*, 602 F. Supp. 2d at 1210–11.

25. *Id.* at 1211.

26. *Id.* at 1211–12.

27. *Id.* at 1211.

28. More precisely, the Southern District of New York's interpretation of Delaware law. *Id.* at 1211–13.

29. *Id.* at 1213.

30. 15 U.S.C. § 78p(b) (2006).

## III. SIGNIFICANT LEGAL BACKGROUND

A. *Interpreting the Scope and Demand of Section 16(b)*

With the rest of the Exchange Act, Section 16(b) was passed by Congress in an effort to ensure a “fair and honest market” where participants had access to all relevant information.<sup>31</sup> Specifically, Congress included Section 16(b) to level the playing field for outside stockholders by preventing corporate insiders from making short-swing speculative trades based upon their access to sensitive inside information.<sup>32</sup> Due to the difficulty in policing whether a trade was actually made based on inside information, however, Section 16(b) imposes strict liability and requires a corporate insider to surrender any profits made in a short-swing trade, regardless of the basis of the trade.<sup>33</sup> Thus, Congress intended Section 16(b) to be an “arbitrary rule capable of easy administration.”<sup>34</sup>

In interpreting Section 16(b), courts have taken significant care to interpret its scope in light of this history, purpose, and text. Thus, where the terms of Section 16(b) are subject to differing constructions, they have been “given the construction that best serves the congressional purpose of curbing short-swing speculation by corporate insiders.”<sup>35</sup> For example, with respect to the scope of transactions covered by the statute, courts have been unyieldingly strict in carrying out the congressional design of “arbitrary and sweeping coverage.”<sup>36</sup> Requiring such “meticulous observance” of the statute, courts have reasoned, is acceptable not only because the text of Section 16(b) is strict, but also because Section 16(b) imposes a relatively light penalty by only requiring disgorgement of profits made within six months and by only requiring profits to be paid back to the issuer.<sup>37</sup> Thus, with regard to the scope of Section

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31. *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235 (2d Cir. 1943).

32. *Id.*

33. *See, e.g., Allis-Chalmers Mfg. Co. v. Gulf & W. Indus., Inc.*, 527 F.2d 335, 356 (7th Cir. 1975) (noting that the approach taken by Congress “maximize[s] the ability of the rule to eradicate speculative abuses by reducing difficulties in proof” (quoting *Bershad v. McDonough*, 428 F.2d 693, 696 (7th Cir. 1970))).

34. *Bershad*, 428 F.2d at 696.

35. *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 424 (1972).

36. *Bershad*, 428 F.2d at 696; *see Petteys v. Butler*, 367 F.2d 528, 532 (8th Cir. 1966) (stating that courts have “liberally construed the rule”).

37. *Bershad*, 428 F.2d at 696–97.

16(b), courts appear to have faithfully implemented both its text and congressional design.

With regard to the standing requirement of Section 16(b), however, it is unclear if courts have been as faithful. The difficulty posed by interpreting the standing requirement of Section 16(b) stems from its similarity to the demand requirements found in traditional derivative suits, where a shareholder sues to “enforce a *corporate* cause of action.”<sup>38</sup> As a prerequisite for standing in a derivative suit, the shareholder must first “demand” that the issuer initiate the suit itself, giving notice of the proposed action to the board.<sup>39</sup> Having received notice of the proposed action, the issuer can then exercise its “reasonable business judgment” and decide whether to pursue the shareholder’s claim itself or to ignore it.<sup>40</sup> Accordingly, when faced with the task of interpreting the standing of Section 16(b) plaintiffs, who sue on behalf of the issuer like in a traditional derivative action,<sup>41</sup> courts have naturally turned to guidance provided by state demand requirements.<sup>42</sup>

Unlike the traditional derivative suit, however, where the shareholder’s cause of action is based on a right of the issuer,<sup>43</sup> Section 16(b) confers a primary right to plaintiffs, giving standing to shareholders when the issuer “fail[s] or refuse[s] to bring such suit within sixty days after request.”<sup>44</sup> Thus, by applying potentially conflicting state law in a Section 16(b) claim, courts have pushed the provision into the murky realm of corporate law federalism, where congressional design can meet head-to-head with state corporate governance.

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38. *Ross v. Bernhard*, 396 U.S. 531, 534 (1970) (emphasis added). This language of the Court highlights that in derivative suits the cause of action is derived from a right of the corporation, not the shareholder. Significantly, this does not mean that all suits brought on behalf of the corporation are derivative, because the cause of action may exist independently with the shareholder. *See Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 535 n.11 (1984).

39. *See Daily Income Fund*, 464 U.S. at 530–33.

40. *Id.* at 533.

41. *See infra* notes 78–79 and accompanying text.

42. *See, e.g., Burks v. Lasker*, 441 U.S. 471, 477–78 (1979).

43. *Daily Income Fund*, 464 U.S. at 530–33.

44. 15 U.S.C. § 78p(b) (2006).

623 *Applying Delaware's Demand Requirement to Section 16(b)**B. Corporate Law Federalism: Burks Answers and Kamen Reaffirms*

The interplay between federal securities law and state corporate governance is as old as the Securities Act of 1933<sup>45</sup> and as new as the Sarbanes-Oxley Act of 2002.<sup>46</sup> Even so, Congress has typically left corporate governance in the hands of the states.<sup>47</sup> Likewise, the courts have been reluctant to use federal law to override principles of state corporate governance,<sup>48</sup> reasoning that “[c]orporations are creatures of state law.”<sup>49</sup> However, despite this rationale and in light of perceived failures of state corporate law in response to various crises, the federal government has increasingly “pulled more and more of the basic concerns of state corporate law into the regulatory ambit of federal law.”<sup>50</sup> This infringement of federal securities laws on areas of corporate governance has posed difficult questions regarding the continuing role of the states in governing corporate fiduciary relationships, particularly regarding derivative actions.<sup>51</sup>

Amid this confusion, the Supreme Court stepped forward in *Burks v. Lasker* and provided a framework for courts faced with an overlap between securities law and state corporate law.<sup>52</sup> In *Burks*, shareholders brought a derivative suit against several of the company’s directors for an alleged violation of the Investment Company Act of 1940 (ICA), a federal securities regulation.<sup>53</sup> In response, nondefendant directors of the company moved to dismiss the suit in federal court as contrary to the company’s interests.<sup>54</sup>

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45. Faith Stevelman, *Regulatory Competition, Choice of Forum, and Delaware's Stake in Corporate Law*, 34 DEL. J. CORP. L. 57, 89 (2009).

46. See Chris Brummer, *Corporate Law Preemption in an Age of Global Capital Markets*, 81 S. CAL. L. REV. 1067, 1070 (2008); Robert B. Thompson, *Delaware, the Feds, and the Stock Exchange: Challenges to the First State as First in Corporate Law*, 29 DEL. J. CORP. L. 779, 791–92 (2004) (stating that by enacting sections of Sarbanes-Oxley, “Congress has, for the first time, taken away the right of Delaware to leave this space vacant”).

47. See *Burks*, 441 U.S. at 477.

48. See, e.g., *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977).

49. *Cort v. Ash*, 422 U.S. 66, 84 (1975).

50. Sean J. Griffith & Myron T. Steele, *On Corporate Law Federalism: Threatening the Thaumatrope*, 61 BUS. LAW. 1, 1 (2005); see Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2494–95 (2005) (noting that “scandals call for quick action” from Congress where “Delaware acts slowly”).

51. See *Burks*, 441 U.S. at 471; *In re Sapient Corp. Derivative Litig.*, 555 F. Supp. 2d 259, 264 (D. Mass. 2008); Brummer, *supra* note 46, at 1069–70.

52. *Burks*, 441 U.S. at 471.

53. *Id.* at 473–74.

54. *Id.*

Thus, the case presented the question of whether the directors had the power to terminate a derivative suit brought as a federal cause of action.<sup>55</sup> Under state law, the directors clearly had the power to terminate the suit, but at the same time, shareholders possessed a federal right of action.<sup>56</sup>

The Court proceeded by establishing a baseline for similar cases: because Congress generally enacts new securities law in the “background of existing state law,” courts should first look to the relevant state’s corporate law to determine the proper relationship between shareholders and directors.<sup>57</sup> Next, the Court performed a “consistency test,” and determined that the state law in question was consistent with the policy of the ICA.<sup>58</sup> In explaining this test, the Court noted that “federal courts must be ever vigilant to insure that application of state law poses ‘no significant threat to any identifiable federal policy or interest’”<sup>59</sup> and that state law should never “be allowed to destroy the *federal* right.”<sup>60</sup>

In 1991, the Supreme Court reaffirmed the basic holding of *Burks*—defer to state law unless it is inconsistent with federal policy—in *Kamen v. Kemper Financial Services*.<sup>61</sup> In that case, the Court rejected the Second Circuit’s creation of new federal common law in assessing the futility of demand.<sup>62</sup> Instead, the Court held that state law should provide the basis of the ICA demand requirement, reasoning that state law was consistent with the ICA in placing limits on the power of directors.<sup>63</sup> Thus, the holdings and reasoning of the Supreme Court in *Burks* and *Kamen* provided a workable method for courts to navigate the interstices and interaction of federal securities law and state corporate governance.

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55. *Id.* at 474.

56. *Id.* Because the ICA does not create an express right of action, the Court assumed for purposes of the case that the shareholders had an implied right of action. *Id.*

57. *Id.* at 478.

58. *Id.* at 480 (internal quotation marks omitted).

59. *Id.* at 479 (quoting *Wallis v. Pan Am. Petroleum Corp.*, 384 U.S. 63, 68 (1966)).

60. *Id.* (emphasis added) (quoting *Bd. of Comm’rs of Jackson Cnty. v. United States*, 308 U.S. 343, 350 (1939)) (internal quotation marks omitted).

61. 500 U.S. 90, 108 (1991). While similar, one important distinction can be made between the fact patterns of *Burks* and *Kamen*. Whereas the plaintiff in *Burks* was assumed to have asserted an implied right of action under *federal* law, 441 U.S. at 474, the plaintiff in *Kamen* asserted a traditional derivative action claim—a *state* cause of action, 500 U.S. at 95.

62. *Kamen*, 500 U.S. at 109.

63. *Id.* at 108–09.

## IV. THE COURT'S DECISION

In *Simmonds*, the Ninth Circuit upheld the dismissal of the plaintiff's Section 16(b) suit based on her failure to satisfy Delaware's demand requirement.<sup>64</sup> In reaching its decision, the court first decided Delaware law should govern.<sup>65</sup> The court then concluded that, under Delaware law, Ms. Simmonds's demand letters were insufficient to confer standing.<sup>66</sup>

*A. Application of Burks and Kamen*

After explaining the requirements and purpose of Section 16(b), the Ninth Circuit addressed how the demand requirement of Section 16(b) should be interpreted. The court proceeded by citing the holding in *Burks* as parroted in *Kamen*: “[W]here a gap in the federal securities laws must be bridged . . . federal courts should incorporate *state* law into federal common law unless the particular state law . . . is inconsistent with the policies underlying the federal statute.”<sup>67</sup>

Next, the court summarily applied this rule to Section 16(b) and determined that in this case Ms. Simmond's standing to make the claim should be determined by state corporate law.<sup>68</sup> Thus, the court concluded, the adequacy of demand in Section 16(b) suits hinged on the application of state substantive law, and as all the issuers were Delaware corporations, Delaware law would apply in this case.<sup>69</sup> Before doing so, the court did note, as required under *Burks*, that it had a duty to determine if “there is a conflict between Delaware law and federal law.”<sup>70</sup> However, the court only considered the purpose of Delaware's demand requirement and failed to consider whether that purpose was consistent with the federal policies underlying Section 16(b).<sup>71</sup> In fact, the court seemed to reverse the analysis used in *Burks*, stating that it “must ‘approximate state law as closely as

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64. *Simmonds v. Credit Suisse Sec. (USA) LLC*, 638 F.3d 1072, 1094 (9th Cir. 2011), *cert. denied*, 131 S. Ct. 3063 (2011), *and cert. granted*, 131 S. Ct. 3064 (2011).

65. *Id.* at 1088–89.

66. *Id.* at 1089–94.

67. *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 108 (1991).

68. *Simmonds*, 638 F.3d at 1088.

69. *Id.* at 1088–89.

70. *Id.* at 1089.

71. *Id.*

possible in order to make sure that the vindication of the *state* right is without discrimination because of the federal forum.”<sup>72</sup>

*B. Application of Delaware’s Demand Requirement*

Having decided to apply Delaware demand law, the Ninth Circuit concluded that Ms. Simmonds’s demand letters to the issuers were insufficient to confer standing in her Section 16(b) claim.<sup>73</sup> Specifically, while Ms. Simmonds had met the first prong of Delaware’s test for adequacy by alleging a “closed set of wrongdoers,” she had failed to satisfy the second and third prongs of the test by not identifying the actual wrongdoing and the legal action she wished the issuers to take.<sup>74</sup> In the end, the court reasoned, Ms. Simmonds did not give the issuers sufficient information to investigate any wrongdoing.<sup>75</sup>

V. ANALYSIS

Although the outcome of *Simmonds* may have been correct regardless of whether state law was applied, the analysis is troubling because the court failed to apply the consistency test of *Burks* and, accordingly, failed to consider the fit between Delaware’s demand requirement and Section 16(b). Given the lack of emphasis by prior courts on the *Burks* consistency test and considering that the application of state corporate law is routine in many securities claims, the Ninth Circuit’s actions in *Simmonds* do not seem extraordinary. Ex ante, however, failure to apply the consistency test of *Burks* will allow state corporate law to frustrate the objectives of federal securities law and to impede otherwise meritorious securities claims.

*A. Consistency of Demand Requirements with the Text and Purpose of Section 16(b)*

Had the Ninth Circuit applied the *Burks* consistency test, it likely would have found Delaware demand law to be inconsistent with the text and purpose of Section 16(b). As a starting point, Section 16(b)

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72. *Id.* (emphasis added) (quoting *Orkin v. Taylor*, 487 F.3d 734, 741 (9th Cir. 2007)).

73. *Id.* at 1094.

74. *Id.* at 1092.

75. *Id.* at 1093.

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itself indicates that the statute is unique when compared to other federal securities laws. Unlike the ICA, for example, which only allows shareholder suits in response to a breach of fiduciary duty,<sup>76</sup> Section 16(b) bypasses the judgment of directors by giving shareholders an express right to sue in the absence of director action.<sup>77</sup> Indeed, courts and commentators have reasoned that Section 16(b) claims are not derivative suits at all<sup>78</sup> and, therefore, are not subject to termination by director action.<sup>79</sup>

The congressional design of Section 16(b) confirms this conclusion. Congress passed Section 16(b) to increase the power of shareholders vis-à-vis corporate insiders and to correct “widespread abuse of . . . fiduciary relationships,”<sup>80</sup> showing congressional intent to affirmatively infringe upon a traditional area of state corporate governance. This reasoning resonates with Supreme Court dicta in *Burks* stating that Section 16(b) authorizes shareholder suits “notwithstanding the decision of the board of directors not to sue”<sup>81</sup> and is an example of a statute where “Congress did intend to prevent board action from cutting off derivative suits.”<sup>82</sup>

In contrast, the purpose of Delaware demand law dictates precisely the opposite. Generally, demand law reinforces the ability of directors to determine the best interests of the corporation in deciding whether to pursue litigation.<sup>83</sup> Specifically, even if a

76. Investment Company Act of 1940 § 36(b), 15 U.S.C. § 80a-35(b) (2006); *see Burks v. Lasker*, 441 U.S. 471, 484 (1979) (stating that, in the ICA, Congress intended to maintain the ability of directors to terminate derivative suits).

77. 15 U.S.C. § 78p(b) (2006).

78. *See, e.g., Dottenheim v. Murchison*, 227 F.2d 737, 738 (5th Cir. 1955) (“[Section 16(b)] creates a new cause of action, which, while similar in some respects to a secondary or derivative right, is not such a right at all. It is in reality a primary right.”); Arnold S. Jacobs, *An Analysis of Section 16 of the Securities Exchange Act of 1934*, 32 N.Y.L. SCH. L. REV. 209, 570 (1987) (“[T]he thoughtful decisions addressing the issue conclude that a section 16(b) suit is not a derivative action.”).

79. *See* John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 289 (1981) (noting that the text of Section 16(b) “reflect[s] a strong statutory policy giving the shareholder-plaintiff the ultimate discretion” regarding the litigation); Jacobs, *supra* note 78, at 571.

80. *Adler v. Klawans*, 267 F.2d 840, 844 (2d Cir. 1959); *see supra* Part III.A.

81. *Burks*, 441 U.S. at 484 n.13.

82. *Id.* at 484.

83. *See Allison ex rel. Gen. Motors Corp. v. Gen. Motors Corp.*, 604 F. Supp. 1106, 1117 (D. Del. 1985), *aff'd*, 782 F.2d 1026 (3d Cir. 1985) (“Decisions as to how and on what theory the corporation will pursue wrongdoers are the proper province of the Board of

shareholder makes sufficient demand to directors, the directors' decision to pursue the claim is entitled to deference under the business judgment rule, normally "an insuperable barrier."<sup>84</sup> Such deference, which may deter plaintiffs from making demand at all, directly conflicts with the text of Section 16(b), which expressly allows a shareholder suit if the issuer "refuse[s] to bring such suit."<sup>85</sup> Thus, whereas demand requirements create a powerful screen for directors to use in blocking shareholder suits,<sup>86</sup> Section 16(b) appears to poke a small hole.

Recognizing this inherent conflict between some remedial securities laws and state demand requirements is not novel. In *Galef v. Alexander*, for example, the Second Circuit recognized the conflict between state demand requirements and a shareholder claim brought under Section 14(a) of the Exchange Act.<sup>87</sup> There, the court concluded that federal policy prevented defendants from using the business judgment rule to dismiss Section 14(a) claims.<sup>88</sup> Other courts have reached similar conclusions, although none have addressed the federal policy underlying Section 16(b).<sup>89</sup>

Finally, the holding of *Kamen* did not control the Ninth Circuit's decision to apply Delaware's demand requirement. As noted earlier, although the *Kamen* Court refused to create a federal common law demand requirement, it only did so after confirming that the applicable state law would be consistent with the ICA.<sup>90</sup> The applicable state law in that case was consistent with the federal policy invoked in the ICA because the state law *limited* the power of

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Directors."); see also Deborah A. DeMott, *Demand on Directors—Rationales for Demand*, in *SHAREHOLDER DERIVATIVE ACTIONS LAW & PRACTICE* § 5:9 (2011).

84. John C. Coffee, Jr., *New Myths and Old Realities: The American Law Institute Faces the Derivative Action*, 48 *BUS. LAW.* 1407, 1411 (1993); see *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (explaining the importance of the business judgment rule in derivative actions), *overruled by* *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

85. 15 U.S.C. § 78p(b) (2006).

86. See Coffee, *supra* note 84, at 1411.

87. See *Galef v. Alexander*, 615 F.2d 51, 64 (2d Cir. 1980).

88. *Id.*

89. See, e.g., *Miller v. Am. Tel. & Tel. Co.*, 507 F.2d 759, 762 (3d Cir. 1974); *Wolf v. Frank*, 477 F.2d 467, 477 (5th Cir. 1973); *In re Westinghouse Sec. Litig.*, 832 F. Supp. 989, 998 (W.D. Pa. 1993). *But see* Donald E. Schwartz, *Federalism and Corporate Governance*, 45 *OHIO ST. L.J.* 545, 580 (1984).

90. *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 108–09 (1991).

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directors by creating a futility exception to the normal demand requirement.<sup>91</sup>

Thus, in light of these conflicting purposes, if the Ninth Circuit had performed a *Burks* consistency test, it likely would have found Delaware's demand requirement to be inconsistent with the text and purpose of Section 16(b). Accordingly, the court should not have applied Delaware demand law to dismiss Ms. Simmonds's suit.<sup>92</sup>

*B. Ex Ante Implications*

*1. Unnecessary federal displacement*

If state corporate law—like the demand requirement imposed in *Simmonds*—infringes upon the enforcement of federal policy, “media saliency” and public fervor may prompt Congress to expressly preempt the area.<sup>93</sup> For an example of a powerful federal response to a perceived failure of corporate governance, one need only look to the more recent scandals involving Enron, WorldCom, and others. In response to what many perceived as deficiencies in general corporate governance, Congress and other authorities enacted the Sarbanes-Oxley Act of 2002, which included a “wide array of corporate governance requirements”<sup>94</sup> and “initiatives that mandate board structure and authority.”<sup>95</sup>

Although some argue that federal displacement of state corporate governance is beneficial,<sup>96</sup> such displacement should only occur

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91. *Id.* at 108.

92. Although alternative methods by which the court could have decided the case are outside the limited scope of this Note, the court did have viable options. For example, if it determined that Delaware's demand law was inconsistent with Section 16(b), the court could have fashioned its own federal common law requirement for Section 16(b) claims. See *Kamen*, 500 U.S. at 97 (stating that for federal statutes, “any common law rule necessary to effectuate a private cause of action under that statute is necessarily federal in character”). Indeed, this approach seems to be the most consistent with *Burks*, where the Supreme Court used Section 16(b) as an example of a statute where Congress did not intend the normal state corporate governance rules to apply. See 441 U.S. at 484 & n.13.

93. Roe, *supra* note 50, at 2493 (“[W]hen media saliency puts the matter on the federal agenda . . . Delaware loses its dominance.”).

94. William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 955 (2003).

95. Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 597 (2003).

96. See, e.g., William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 705 (1974). For an argument against federalization of corporate law, see,

where state law is inadequate in achieving the results for which it was designed. In *Simmonds*, for example, one can imagine the result if the plaintiff had, on the merits, a valid Section 16(b) claim. Delaware demand law would have impeded an otherwise valid federal securities claim, leading to speculation that Delaware's demand requirement should be displaced in order to prevent the frustration of federal policy. However, Delaware's demand requirement was simply not designed to address the federal policy underlying Section 16(b) and, therefore, should not be discarded as inadequately fulfilling a purpose it was never intended to achieve.

Thus, the consistency test outlined by the Supreme Court in *Burks* plays an important role in corporate law federalism by preventing conflict between federal policies and state corporate law. If courts skip the consistency test and automatically turn to state law to fill the gaps of securities laws, they may not only impede meritorious securities claims but also unnecessarily prompt preemption of state corporate law.

## 2. Epilogue

While not in response to the court's decision in *Simmonds*, the Financial Industry Regulatory Authority (FINRA) has already, and predictably, addressed concerns related to the suit.<sup>97</sup> In 2011, FINRA adopted regulations to bar "spinning,"<sup>98</sup> one of Ms. Simmonds's chief complaints.<sup>99</sup> The regulations stemmed from the recommendations of an IPO advisory committee formed to respond to the 1998–2000 hot issue market—a market where former WorldCom chief executive Bernard Ebbers earned \$11.5 million over five years while his company doled out \$76 million in banking fees at the same time.<sup>100</sup> The advisory committee's first recommendation called for each board of directors to contain an

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e.g., Chandler & Strine, *supra* note 94, at 1005.

97. See Notice of Filing of Proposed Rule Change To Amend FINRA Rule 5131 (New Issue Allocations and Distributions), 76 Fed. Reg. 24,076 (Apr. 29, 2011).

98. *Id.* at 24,077 (stating that the proposed rule prohibits spinning, "an underwriter's allocation of IPO shares to directors or executives of investment banking clients in exchange for receipt of investment banking business"); see *supra* notes 14–15 and accompanying text.

99. *Simmonds v. Credit Suisse Sec. (USA) LLC*, 638 F.3d 1072, 1093 (9th Cir. 2011) *cert. denied*, 131 S. Ct. 3063 (2011), and *cert. granted*, 131 S. Ct. 3064 (2011).

100. Randall Smith, *Rule over the Abuse of IPOs Is Delayed*, WALL ST. J., May 3, 2011, at C1.

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“IPO pricing committee,”<sup>101</sup> foreshadowing further federal displacement of state corporate law. All of these proposed reforms may not be necessary, however, because a mechanism to correct some of the abuse may already be in place through Section 16(b), albeit exercised too late in *Simmonds*.

#### VI. CONCLUSION

Whether or not Ms. Vanessa Simmonds had a valid Section 16(b) claim, the Ninth Circuit could have more carefully considered whether Delaware demand law was consistent with the federal policy underlying Section 16(b). Had the court done so, it likely would have found that the text and purpose of Section 16(b) inconsistent with Delaware's demand requirement. Accordingly, the court should not have used Delaware demand law to dismiss the suit.

And although events since the IPO of LinkedIn indicate that we are not likely to witness another hot issue market in the near future,<sup>102</sup> one could certainly occur again and would be accompanied by more securities claims.<sup>103</sup> If courts fail to consider the fit between federal securities law and state corporate law in these cases, they may not only impede valid securities claims, but they might also spur unnecessary displacement of well-functioning state law.

*Joseph Orien*\*

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101. NYSE/NASD IPO ADVISORY COMMITTEE, *supra* note 15, at 4. For an overview and analysis of the proposed reforms, see Hurt, *supra* note 7, at 771–82.

102. See Lynn Cowan & Randall Smith, *Global Finance: That IPO Pop?*, WALL ST. J., Sept. 15, 2011, at C3.

103. See Hurt, *supra* note 7, at 785–86, 790 (“[A]nother IPO boom is certain to appear, and retail investors will again fall prey to the abuses inherent in the IPO process.”).

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