***Stark Trading v. Falconbridge Ltd.*: Seventh Circuit Affirms Dismissal of 10b-5 Claim on Evidence of Plaintiffs' Contemporaneous Knowledge of Alleged Fraud**

On January 5, 2009, the United States Court of Appeals for the Seventh Circuit, in an opinion by Judge Richard Posner, found that a plaintiff had not proven the detrimental reliance element of a Securities Exchange Commission Rule 10b-5 claim where the plaintiff voiced suspicion that a tender offer may have been fraudulent, but nonetheless agreed to go through with the deal.[1] The opinion holds that where a sophisticated institutional investor believes a tender offer to be fraudulent, it should hold its stock and try to block the deal, rather than tender its shares and retrospectively sue for securities fraud.

I. Facts and Procedural History

In February 2004, Brascan Management Corp. ("Brascan"), a Canadian asset management company, held 41% of the shares of Noranda Corp. ("Noranda"), a Canadian mining company. Noranda in turn owned 59% of Noranda's subsidiary, Falconbridge Corp. ("Falconbridge"). Falconbridge's remaining shares were widely held, including by Stark Trading and Shepherd Investments International, Ltd. ("Plaintiffs"), a pair of hedge funds.

Brascan decided to divest its holdings in Noranda, and toward that end caused Noranda to launch complicated two-part tender offer, announced on March 9, 2005. The first part of the transaction was an issuer bid by Noranda, in which Noranda invited its common stock holders, including Brascan, to exchange their common stock for junior preferred stock. Noranda agreed to then redeem the preferred shares for $25 per share in cash, above the historical trading value of Noranda common stock. Noranda needed to reacquire a large amount of its common stock for the second part of the transaction, in which Noranda offered the minority shareholders of Falconbridge 1.77 shares of Noranda common stock for each share of Falconbridge stock tendered to Noranda. The deal required the approval of half the Falconbridge minority shareholders, weighted by number of shares held. Both the issuer bid and the tender offer commenced on March 24, 2005, and ended on May 5, 2005.

The tender offer was completed successfully, with Plaintiffs, who had begun buying Falconbridge stock on March 17, 2005, tendering their shares along with the requisite number of other minority shareholders before the May 5 deadline. Three months later, Noranda and Falconbridge merged into a single entity, Falconbridge Ltd., squeezing out non-tendering shareholders.

At some point prior to the May 5 deadline, however, the Plaintiffs became aware of what they claimed were "inaccuracies in the offering documents."[2] On April 29, 2005, the Plaintiffs submitted a lengthy letter to the Ontario Securities Commission ("O.S.C."), alleging that the investment bank that had provided a valuation of Falconbridge for the tender offer and the Falconbridge special committee that had advised minority shareholders to accept the offer suffered from conflicts of interest. Plaintiffs further alleged that Noranda had concealed those conflicts, and had overstated the value of its common stock, allowing Noranda to buy out the Falconbridge minority shareholders at an unfairly low price. The Plaintiffs did not share their concerns with the other minority shareholders and took no other action to block the deal, ultimately deciding to tender their Falconbridge shares.

The allegations in the letter to the O.S.C. would ultimately become the basis of Plaintiff's Rule 10b-5 securities fraud claim against Brascan and Falconbridge, Ltd., filed in federal district court in the Eastern District of Wisconsin in November 2005. On January 14, 2008, the district court (Goodstein, M.J.) dismissed Plaintiffs'

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1 *Stark Trading* v. *Falconbridge Ltd*., No. 05-C-1167 (7th Cir. Jan. 5, 2009).

2 *Id*. at 5.

claims on various grounds, including failure to adequately plead the detrimental reliance element of securities fraud.[3] The district court held that the Plaintiffs' letter to the O.S.C. demonstrated knowledge of the actions that it subsequently claimed were fraudulent, meaning that Plaintiffs could not have relied to their detriment on a deceptive scheme. The district court said that if the Plaintiffs truly suspected the transaction was fraudulent, they should have held their shares and exercised their dissenters' rights; it would be "simply illogical" to let sophisticated investors wield the securities fraud laws as a sword where they accepted the risks of the transaction even after declaring it a fraud.[4] The securities laws "are available only for those who were unknowingly deceived and tendered their shares, or non-tendering shareholders who suffered an injury as a result of a sufficient number of other shareholders tendering shares as a result of the defendants' fraudulent statements."[5] Finding that Plaintiffs did not fit into either of these categories, the district court dismissed Plaintiffs' claim. The Plaintiffs appealed.

II. Seventh Circuit's Decision

The Court of Appeals received Plaintiffs' appeal with skepticism, affirming the district court on reliance grounds without addressing scienter or the other issues litigated below. The Court began by stating that "a claim of fraud fails if there is no proof that the plaintiff relied to his detriment on the defendant's misrepresentations or misleading omissions,"[6] and that "without reliance, fraud is harmless."[7]

Like the district court, the Court of Appeals found Plaintiffs' letter to the O.S.C. fatal to the claim of reliance. In that letter, Plaintiffs tried to justify their decision to tender their shares despite their allegations of fraud, claiming that they feared they would be squeezed out of an eventual merger if they failed to tender their shares and the tender offer succeeded anyway. They would then be without remedy, since the governing Canadian law, unlike U.S. law, would not provide them protection against a predatory majority shareholder.

This argument did not impress the Court of Appeals. Judge Posner noted that Plaintiffs, as hedge funds, were sophisticated institutional investors who knew at the time they acquired an interest in Falconbridge that they were investing in a majority-owned subsidiary and that Canadian law would afford them fewer minority shareholder rights than U.S. law.[8] The Court of Appeals also seemed to find relevant that Plaintiffs began purchasing Falconbridge stock on March 17, 2005, more than a week after the tender offer was announced. The timing of Plaintiffs' purchases suggested to the Court of Appeals that Plaintiffs must have thought Falconbridge was undervalued by the market, and that Noranda would think the same thing, such that Noranda would have an incentive to "buy out the minority shareholders before the market revalued Falconbridge upwards."[9] This would perhaps "not be a nice way to treat minority shareholders, but 'securities fraud does not include the oppression of minority shareholders.'"[10]

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3 *Stark Trading* v. *Falconbridge*, *Ltd*., No. 05-C-1167, 2008 WL 153542 at *14 (E.D. Wis. Jan. 14, 2008) (Goodstein, J.).

4 *Id*. at *13.

5 *Id*.

6 *Stark Trading* v. *Falconbridge Ltd*., No. 05-C-1167 (7th Cir. Jan. 5, 2009) at 2 (citing *Dura Pharms*., *Inc*. v. *Broudo*, 544 U.S. 336, 341-42 (2005)).

7 *Id*. (quoting *Dexter Corp*. v. *Whittaker Corp*., 926 F.2d 617, 619 (7th Cir. 1991)).

8 *Id*. at 7.

9 *Id*.

10 *Id*. (quoting *Isquith* v. *Caremark Int'l, Inc*., 136 F.3d 531, 535 (7th Cir. 1998)).

The Court of Appeals noted that Plaintiffs had better options available if they truly believed the tender offer was fraudulent. Plaintiffs could have attempted to dissuade the other minority shareholders from tendering, mailing them copies of the letter to the O.S.C. or publicizing the letter to the financial press and Wall Street analysts.[11] And if other minority shareholders were "too dumb to perceive [the alleged fraud] even after being warned," the Plaintiffs could have sued to enjoin the tender offer, or sought recourse through the fraud-on-the-market doctrine of *Basic*, *Inc*. v. *Levinson*, 485 U.S. 224 (1988).[12]

In the end, however, the Court of Appeals concluded that Plaintiffs did not take those actions because, as their letter to the O.S.C. demonstrated, they went into the transaction with open eyes and were never deceived into relying upon any fraudulent scheme. As Judge Posner put it, "no one who saw through the fraud would be able to sue for fraud, for he could not have relied directly or indirectly. And that was the plaintiffs' position."[13] As sophisticated investors, the Plaintiffs must have considered tendering their shares and then bringing suit "a better deal than holding on to their shares and . . . trying to defeat the tender offer."[14] The Court of Appeals opined that "[t]hat is not a strategy that the courts should reward in the name of rectifying securities fraud."[15]

III. Significance of the Decision

Sophisticated, opportunistic, institutional investors who complain about a transaction, but nevertheless proceed with it, may be barred from suing for fraud when it becomes apparent that they have gotten a bad deal. In the Seventh Circuit, would-be securities fraud litigants who say out loud that they think a transaction is fraudulent should also be prepared to act as if they mean it.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.

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11 *Id*. at 6, 8.

12 *Id*. at 8.

13 *Id*. at 9.

14 *Id*.

15 *Id*.

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