IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

MICHAEL STEINHARDT, HERBERT CHEN, DEREK SHEELER, STEINHARDT OVERSEAS MANAGEMENT, L.P., and ILEX PARTNERS, L.L.C., individually and on behalf of all others similarly situated,	)	
Plaintiffs,	)	
v.	)	C.A. No. 5878-VCL
ROBERT HOWARD-ANDERSON, STEVEN KRAUSZ, ROBERT ABBOTT, ROBERT BYLIN, THOMAS PARDUN, BRIAN STROM, ALBERT MOYER, and OCCAM NETWORKS, INC.,	)	
Defendants.	)	

<u>OPINION</u>

Date Submitted: November 21, 2011
Date Decided: January 6, 2012

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Peter J. Walsh, Jr., Ryan W. Browning, POTTER ANDERSON & CORROON, LLP, Wilmington, Delaware; Jerome F. Birn, Jr., Ignacio E. Salceda, Gregory L. Watts, Clay Basser-Wall, WILSON SONSINI GOODRICH & ROSATI, P.C., Palo Alto, California; *Attorneys for Defendants.*

LASTER, Vice Chancellor.

Plaintiffs Derek Sheeler, Herbert Chen, Michael Steinhardt, Steinhardt Overseas Management, L.P., and Ilex Partners, L.L.C. filed this lawsuit on behalf of a class of stockholders of Occam Networks, Inc. ("Occam" or the "Company"). The defendants have moved for sanctions against all plaintiffs other than Sheeler for trading on the basis of confidential information obtained in this litigation.

With respect to Steinhardt and the funds, the motion is granted. Consistent with prior rulings by this Court when confronted with representative plaintiffs who have traded while serving in a fiduciary capacity, Steinhardt and the funds are dismissed from the case with prejudice, barred from receiving any recovery from the litigation, required to self-report to the Securities and Exchange Commission, directed to disclose their improper trading in any future application to serve as lead plaintiff, and ordered to disgorge profits in the amount of $534,071.45. With respect to Chen, the motion is denied.

I. FACTUAL BACKGROUND

On November 21, 2011, I held an evidentiary hearing on the sanctions motion. Chen and Steinhardt testified live. The paper record included depositions of Steinhardt and Chaim Rosenberg (Steinhardt's principal trader), two depositions of Chen, three affidavits from Chen, documentary evidence relating to the trading allegations, and additional deposition transcripts and documents from the injunction phase of the case. What follows are my findings of fact for purposes of the sanctions motion.

A. The Relevant Parties

Before its acquisition by Calix, Inc., Occam was a publicly traded Delaware corporation headquartered in Santa Barbara, California. Occam developed, marketed, and supported broadband access products designed to enable telecommunications service providers to offer advanced voice, video, and high speed broadband services over copper and fiber optic networks.

Calix was and remains a publicly traded Delaware corporation headquartered in Petaluma, California. Before acquiring Occam, Calix was one of Occam's primary competitors.

Plaintiff Steinhardt has been a professional investor for nearly forty-five years. He reportedly has a net worth of approximately $500 million and has been described as "one of the most successful investors in the history of Wall Street." Aff. of Clayton Basser-Wall, Ex. 18 (Rediff.com, *World's 10 Greatest Investors*, http://business.rediff.com/slide-show/2010/mar/05/slide-show-1-worlds-10-greatest-investors.htm (last updated Mar. 5, 2010) (last visited Jan. 4, 2012)). From 1967 until 1995, Steinhardt managed a hedge fund. Since liquidating the fund in 1995, Steinhardt has managed his own money. Plaintiffs Steinhardt Overseas Management, L.P., and Ilex Partners, L.L.C. (jointly, the "Funds") are both managed by Steinhardt.

Plaintiff Chen has been a professional investor for nearly twenty-five years. After receiving his MBA from Wharton in 1987, Chen joined Steinhardt's firm as an analyst and eventually became a partner. In 1993, Chen left Steinhardt's employ to trade on his own. Around 2005, he established a fund called Lattanzio Chen Partners, L.P. with another Steinhardt alumnus. Chen also manages his own money. Throughout his post-Steinhardt career, Chen has worked out of Steinhardt's offices, where he receives space free of charge. Chen's office is roughly twenty feet away from Steinhardt's.

Before the merger, Chen beneficially owned 619,946 shares of Occam, representing 2.9% of its outstanding stock. Chen's pre-merger holdings of Occam amounted to approximately 20% to 25% of his net worth. In his deposition, Chen characterized himself as a "champion" and "advocate" for Occam. Using pseudonyms, he frequently posted about Occam on message boards hosted by Yahoo! and Nyquist Forums. Chen also wrote research articles about Occam on SeekingAlpha.com under the alias "Mr. Bert."

Chen was the catalyst for Steinhardt and the Funds' investment in Occam. In January 2009, the Lattanzio-Chen fund needed liquidity to meet a margin call. Chen offered a block of Occam shares to Steinhardt at a distressed price, which Steinhardt found attractive. As a result of the transaction and other smaller purchases, Steinhardt came to own 2,839,983 shares of Occam, representing 13.5% of its outstanding stock. At Chen's urging, Steinhardt and the Funds became representative plaintiffs in this action.

Plaintiff Sheeler beneficially owned 556,570 shares of Occam, representing 2.6% of its outstanding stock. Sheeler was another frequent poster about Occam on the Nyquist Forums and Yahoo! message boards under the alias "Toad680." Sheeler also blogged about Occam under the alias "Derek Kent."

B. Occam And Calix Announce The Merger.

On September 16, 2010, Occam and Calix announced an agreement and plan of merger. Under the agreement, Occam would merge with a wholly owned acquisition subsidiary of Calix, and each share of Occam common stock would be converted into the right to receive $3.8337 in cash and 0.2925 shares of Calix common stock (the "Merger"). On the date of announcement, the Merger consideration had an implied value of $7.75 per Occam share.

On September 27, 2010, plaintiffs Chen, Steinhardt, and Sheeler sent a fifteen-page letter to defendant Steven Krausz, the Chairman of Occam's Board of Directors, in which they detailed their objections to the Merger. In the opening two paragraphs, the plaintiffs described themselves as "significant shareholders of the company" and noted that "we currently own or have investment control over approximately 4 million shares, or approximately 19% of Occam." JX 4, Ex. 2. The plaintiffs then summarized their concerns:

> Currently, despite giving consideration to the potential of the acquisition, Occam shares closed Friday at just $7.41, representing virtually no premium to the price range since March of this year. Further, we note that the structure of the proposed deal significantly cashes out Occam shareholders at a critical time, just as revenues are beginning to ramp, while at the same time creating a potentially taxable event.
>
> Therefore, while we appreciate the potential strategic benefits of such a deal, we are firmly opposed to the deal as currently structured and believe it comes nowhere close to recognizing either the intrinsic value of the company's cash flows or, as in the present case, its potential strategic value to a third party. We believe that the board of directors of Occam has acted, once again, with reckless and wanton disregard for its shareholders, and we hereby demand that the board move immediately to open up the sales process by auctioning the company to the highest bidder.

Id. In the ensuing fourteen pages, the letter criticized the Occam-Calix transaction based on industry reports, the timing of the deal, the potential impact of government stimulus, recent trading prices, the valuation of Occam, how the sale process was conducted, and whether it complied with Delaware law. Later that day, Chen, Steinhardt, and Sheeler filed a Schedule 13D that included the letter as an exhibit.

C. The Plaintiffs File Suit.

On October 6, 2010, the plaintiffs filed this litigation. The original complaint alleged that the Occam directors breached their fiduciary duties in approving the Merger at an unfair price. Because Occam had not yet filed its preliminary proxy statement, the original complaint did not assert any disclosure violations. In the first paragraph of the original complaint, the plaintiffs stressed their combined beneficial ownership of approximately 19% of Occam's outstanding common stock.

Between October 29 and November 2, 2010, Chen sold 31,000 shares of Occam stock at an average price of $7.36 per share, less than the implied value of the Merger consideration on the date of announcement. Chen testified credibly that he sold these shares to generate liquidity for himself and his fund because he anticipated that once a confidentiality order was entered, his ability to trade would be limited.

D. The Confidentiality Order

On November 12, 2010, I approved a Stipulation and Order Governing the Production and Exchange of Confidential Information that the parties had negotiated (the "Confidentiality Order"). Paragraph 8 of the Confidentiality Order provided as follows:

> Confidential Discovery Material, or information derived therefrom, shall be used solely for purposes of this Litigation and in an appraisal proceeding that Plaintiffs in this Litigation may file . . . . Confidential Discovery Material shall not be used for any other purpose, including, without limitation, for any business or commercial purpose or for any other litigation or proceeding. Confidential Discovery Material Parties and non-parties who receive Confidential Discovery Material shall not purchase, sell, or otherwise trade in the securities of any company, including but not limited to Occam and Calix, on the basis of confidential information contained in the Confidential Discovery Material to the extent such information is still confidential at the time of such purchase, sale or trade.

Confidentiality Order ¶ 8. Paragraph 8 thus contained *both* a general requirement that Confidential Discovery Material "be used solely for purposes of this Litigation" (the "Use Restriction") *and* a specific restriction against purchasing, selling, or otherwise trading "in the securities of any company, including but not limited to Occam and Calix, on the basis of confidential information contained in the Confidential Discovery Material" (the "Trading Restriction").

E. The Plaintiffs Pursue An Expedited Injunction Application.

On November 24, 2010, the plaintiffs filed an extensively researched and highly detailed amended complaint. The new pleading spanned 130 pages and contained 322 numbered paragraphs. It continued to challenge the fairness of the transaction and added disclosure claims. Paragraph 1 of the amended complaint again stressed the plaintiffs' combined beneficial ownership of approximately 19% of Occam's outstanding common stock. The plaintiffs further represented that they were "committed to prosecuting this action" on behalf of Occam's public stockholders. *Id.* ¶¶ 309-10. Chen played a major role in drafting the amended complaint.

On December 15, 2010, the plaintiffs moved for a preliminary injunction against the Merger, and the parties thereafter agreed on a reasonable schedule for expedited proceedings. The defendants started their document production on December 1, 2010, ultimately producing over 13,000 pages. Occam's investment banker, Jefferies & Company, Inc. ("Jefferies") started its document production on December 21, eventually producing over 3,000 additional pages. Many of the documents were designated "Confidential" for purposes of the Confidentiality Order. Chen reviewed much of the production personally.

On January 5 and 6, 2011, the plaintiffs deposed defendants Robert Howard-Anderson and Steven Krausz. On January 7, the plaintiffs deposed Jeffrey Snyder, a relatively junior banker on the Jefferies team whom Jefferies designated as its original Rule 30(b)(6) representative. The deposition transcripts were designated "Confidential." Chen reviewed the Howard-Anderson and Krausz deposition transcripts and attended the Snyder deposition.

F. Steinhardt Shorts Calix.

On December 28, 2010, when the defendants' and Jefferies' document productions were nearly complete, Steinhardt began short selling Calix common stock. His sales continued through the closing of the Merger. In total, he sold short 589,097 shares of Calix stock. At the Merger's exchange ratio of 0.2925 Calix shares per Occam share, Steinhardt's short sales equated to selling 2,014,007 shares of Occam common stock.

When Steinhardt started his short selling, he beneficially owned 2,839,983 Occam shares. After his sales, at the time the Merger closed, he effectively held 825,976 Occam shares.

Steinhardt sold Calix short as a way to exit his Occam position. By selling Calix short, Steinhardt could both liquidate his Occam position and "tak[e] advantage of the arbitrage spread that existed between Calix and Occam at that time." Tr. 19. He intended to (and later did) use the shares of Calix stock he would receive when the Merger closed to cover his short sales, even though Steinhardt and his co-plaintiffs were asking the Court to enjoin the closing of the Merger. Steinhardt testified that "based upon everything that [he] knew, there was a very high probability of that merger occurring." Tr. 19. As described below, the universe of "everything that [Steinhardt] knew" included detailed written and oral reports from Chen about the progress of the litigation.

Steinhardt testified that he decided to short Calix after the stock ran up.

> Calix had really gone up a lot. Remember it was issued publicly for the first time, now months ago, I think at $8, and it really had gone up a lot. And the impression I was given from my source, Herb Chen, was that [Calix's CEO] Russo was a hot shot and a little bit of wise-guy and he had promoted the stock and got it up to whatever it was up to before all of this, and there was a bunch of venture capital funds in it. There was a little hype associated with it. It was up a lot.

Steinhardt Dep. 205. Steinhardt further explained his rationale as follows:

> [I]f you make three times your money in a relatively short period, and much of that money is being made in a merger that has aspects to it that are viewed as uncomfortable and even unsavory, then the idea of sticking around isn't all that attractive. Particularly if you are sticking around in a company whose management gooses the stock from the public offering, and gooses the stock again in anticipation of the merger, and has the reputation of being a wise-guy. So who wants to be involved in that sort of

> a management anyway, even if it does have really bullish prospects. Particularly when the stock is up a great deal.

Id. at 219-20. Steinhardt testified that in light of the run-up, "the risk reward was no longer so great," and he was "happy to go home." *Id.* at 206.

G. Steinhardt's Receipt Of Non-Public Information About The Litigation

At the time he decided to sell, Steinhardt admittedly had been receiving regular written and oral updates about the litigation, albeit from Chen rather than from plaintiffs' counsel. Steinhardt did not speak directly with plaintiffs' counsel until May 2011, two days before his deposition. Instead, Chen "acted as a 'conduit' between Mr. Steinhardt and Plaintiffs' counsel" by telling Steinhardt what he learned in conversations with plaintiffs' counsel and by reviewing documents and depositions. Pls.' Reply Br. in Supp. of their Interim Application for Attorneys' Fees and Expenses at 6.

In his deposition, Steinhardt testified about the updates he received:

> Q. How frequently did you receive oral updates from Mr. Chen on the status of this litigation?
>
> A. Once every week or so.
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> * * *
>
> Q. Did Mr. Chen's updates with you include his description of things he was learning about the facts of the case?
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> A. Yes.
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> Q. And did those oral updates include Mr. Chen's description of things he was learning from his review of deposition transcripts?
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> A. I think so.
>
> Q. And did his oral updates with you include his description of information he had learned from documents produced by the defendants in this litigation?

A. I think so.

* * *

Q. But Mr. Chen did provide you with summaries of what he was discovering; correct?

A. Yes.

Q. Did he communicate to you that he believed he was learning more about Occam and this merger than he would have otherwise known?

A. Yes, sir.

Q. Did he in those conversations share some of that new information with you?

A. Yes, sir.

Steinhardt Dep. 73-74, 99; *accord* Tr. 38. During the evidentiary hearing on the motion for sanctions, Steinhardt recalled Chen describing for him some of the information obtained through discovery. Tr. 9.

In addition, Chen provided Steinhardt with regular written updates on the case, which Steinhardt read "thoroughly and carefully." Steinhardt Dep. 85; *see* Tr. 61 (Chen stating that he provided Steinhardt with oral updates and written memos). The updates began before the filing of the lawsuit and continued through at least May 25, 2011, the date of Steinhardt's deposition. Disappointingly, there is no record of any written updates to Steinhardt post-dating December 14, 2010, apparently because Steinhardt threw them away after reading them. The plaintiffs have produced copies of ten written updates that Chen provided to Steinhardt between September 16 and December 14, 2010, but redacted substantial portions of those documents as privileged. Other memos were withheld entirely as privileged.

Chen knew that Steinhardt was selling Calix short and disagreed with his decision. Chen believed that Calix would continue to move higher and argued that Steinhardt should hold. Steinhardt testified that "if it was up to Mr. Chen I would probably still own Calix today." Steinhardt Dep. 199. Chen believes that he warned Steinhardt about trading in light of his status as a representative plaintiff. Tr. 64 ("I believe I mentioned it to him. I don't believe I went into his office and jumped up and down and said 'You can't,' but I believe I said, 'You realize this means you shouldn't trade in Occam.'").

Steinhardt and Chen did not inform plaintiffs' counsel about the short sales. Counsel only learned of the transactions after the defendants served discovery requests directed towards the plaintiffs' trading.

H. The Injunction Decision

On January 24, 2011, I conducted a hearing in open court on the plaintiffs' motion for a preliminary injunction. The hearing was broadcast by Courtroom View Network, and Chen attended in person. At the conclusion of the hearing, I granted the plaintiffs' motion and enjoined the stockholder vote on the Merger pending the issuance of supplemental disclosures and the deposition of one of the lead bankers from Jefferies.

I. Chen's Sale of Occam Shares

On January 25, 2011, Chen sold an additional 2,500 shares of Occam stock. The impetus for the trade appears to have been a margin call. Chen trades through Interactive Brokers, a platform that liquidates stocks automatically to cover any margin deficit at the end of the trading day.

At around 3:45 p.m. on January 25, Chen was notified that he had a margin deficit in his account. Chen is a director of TranSwitch Corporation, by far his largest equity position. As an insider, Chen could not freely sell TranSwitch shares. Chen feared that if he did not sell other shares to raise cash, his broker automatically would liquidate shares from his largest position, creating potential problems for Chen.

Chen testified that he reacted to his predicament by trying to sell shares of Cisco, but mistakenly sold shares of Occam. Chen first offered 2,500 shares via limit order at a price of $8.26 per share. When the limit order did not fill quickly, Chen lowered the limit price to $8.25 per share. Chen dismisses the trade as a "fat-finger" error. Tr. 67.

As the defendants point out, the ticker symbol for Cisco (CSCO) does not closely resemble the ticker symbol for Occam (OCNW). Moreover, on January 25, 2011, Cisco was trading around $20.00 per share, more than twice the limit in Chen's order. Chen testified that he operates his trading program by clicking his mouse on small symbols and trading graphics on his screen, rather than by typing in letters, and he probably clicked in the wrong spot. He also testified that the limit price appears automatically in his program, and he likely did not focus on price. According to Chen, he multitasks while trading like a smart-phone-addicted teenager, including by "entering orders while talking on the phone, or sending instant messages, or calculating margin requirements," or "playing speed chess." Chen Aff. dated Sept. 23, 2011, ¶ 10; Tr. 75. For Chen, "[t]he execution of a small 2,500 share trade (whether in Cisco or most other stocks) is a highly routine event, one that [he] might do dozens of times a day," and it therefore "often does not command [his] full attention." Chen Aff. dated Sept. 23, 2011, ¶ 10.

Sometime after the sale closed, Chen realized that he sold Occam in violation of the Confidentiality Order. At that point, however, Chen could not unwind the sale. He chose not to repurchase the shares, believing that trading Occam twice would be worse than trading once. The sale of 2,500 shares represented less than one-half of one percent of his 554,000 share position.

Chen did not inform plaintiffs' counsel about the transaction. As with Steinhardt's short sales, counsel only learned about it when collecting information to respond to the defendants' trading-related discovery requests.

J. Occam's Stockholders Approve The Merger.

Occam convened and adjourned its special meeting of stockholders and made additional disclosures in a Schedule 14A filed with the SEC on February 7, 2011. At the reconvened special meeting on February 22, 2011, the Merger was approved by the vote of 13,707,405 shares, representing approximately 64% of the 21,557,812 shares outstanding and entitled to vote.

K. Steinhardt Tries To Fade Into The Background.

After the injunction hearing, the defendants served discovery requests seeking information about the plaintiffs' trading activities. Plaintiffs' counsel proposed that in lieu of responding to the discovery requests, Steinhardt would step down as a class representative. When the defendants declined this offer, plaintiffs' counsel suggested that in lieu of producing documents or responding to interrogatories, Steinhardt would sit for a deposition. Again, the defendants declined. Through the ensuing discovery, the defendants learned about Steinhardt's and Chen's trades.

On May 20, 2011, plaintiffs Chen and Sheeler moved for class certification and to be certified as class representatives. Steinhardt and the Funds did not. A footnote in the plaintiffs' opening brief in support of their motion for class certification explained Steinhardt's decision as follows:

> Named plaintiffs Michael Steinhardt, Steinhardt Overseas Management, L.P. and Ilex Partners, L.L.C. remain fully supportive of this Action and believe that class treatment is warranted (with Messrs. Chen and Sheeler as the Class representatives). However, to streamline the litigation and alleviate the burden on them created by Defendants' excessive discovery demands, Mr. Steinhardt and his entities have elected to step down as proposed class representatives.

Pls.' Opening Br. in Supp. of their Mot. for Class Certification 1 n.1. The brief did not disclose or discuss Steinhardt's short sales.

II. LEGAL ANALYSIS

When a stockholder of a Delaware corporation files suit as a representative plaintiff for a class of similarly situated stockholders, the plaintiff voluntarily assumes the role of fiduciary for the class. *See Emerald P'rs v. Berlin*, 564 A.2d 670, 673 (Del. Ch. 1989); *Youngman v. Tahmoush*, 457 A.2d 376, 379 (Del. Ch. 1983). As a fiduciary, the representative plaintiff "owes to those whose cause he advocates a duty of the finest loyalty." *Barbieri v. Swing-N-Slide Corp.*, 1996 WL 255907, at *5 (Del. Ch. May 7, 1996) (internal quotation marks omitted).

This Court has addressed trading by representative plaintiffs in a series of rulings.[1] As the Court has explained, trading by plaintiff-fiduciaries on the basis of information obtained through discovery undermines the integrity of the representative litigation process.[2] Consequently, it is unacceptable for a plaintiff-fiduciary to trade on the basis of non-public information obtained through litigation.[3] Depending on the facts of the case,

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[1] *See In re Netezza Corp. S'holder Litig.*, Consol. C.A. No. 5858-VCS (Del. Ch. Apr. 6, 2011) (TRANSCRIPT) ("Netezza Ruling"); *Berger v. Icahn Enters. L.P.*, C.A. No. 3522-VCS (Del. Ch. Oct. 23, 2009) (TRANSCRIPT) ("Berger Ruling"); *Sample v. Morgan*, C.A. No. 1214-VCS (Del. Ch. Aug. 5, 2008) (TRANSCRIPT) ("Sample Ruling"); *Benton v. Guitar Ctr., Inc.*, C.A. No. 3075-VCS (Del. Ch. Sept. 7, 2007) (TRANSCRIPT) ("Benton Ruling"); *In re Netsmart Techs., Inc. S'holders Litig.*, Consol. C.A. No. 2563-VCS (Del. Ch. May 1, 2007) (TRANSCRIPT) ("Netsmart Ruling II"); *In re Netsmart Techs., Inc. S'holders Litig.*, Consol. C.A. No. 2563-VCS (Del. Ch. April 11, 2007) (TRANSCRIPT) ("Netsmart Ruling I").

[2] *See* Benton Ruling at 77 ("Once you get access to information only for litigation purposes, it's particularly kind of unsightly to trade below a deal and then try to prevent other people from trading on the deal because people get access."); Netezza Ruling at 15-16 ("Once really counsel start getting into it and discussing things, like even whether you're going to expedite a case, you know, even before confidential discovery shifts hands, counsel for the client often knows things that members of the investing public don't -- and members of this court don't. And I care about the representative litigation process. No one wants to shut it down."); *see also* Berger Ruling at 63 ("[W]e're in a court where we believe that representative litigation is important and has value. The more you believe that, the more important it is that it proceed with integrity."); Netsmart Ruling I at 8 ("I believe that the representative litigation process has value. But it only has value when it has integrity. And when its integrity is undermined, you can have -- you can give arguments to people to take down the whole system.").

[3] *See* Berger Ruling at 55-56 ("I think it's far simpler than that, which is you kind of come in to litigation with what you have; and then if you want to sign up for confidential information, you're going to deal with limitations on your ability to buy and sell."); Netsmart Ruling I at 12-14 ("[P]eople don't get to be plaintiffs to go ferret around for nonpublic information and then make their own trading decisions and leave everybody else with the costs."); Benton Ruling at 77 ("You own what you own coming in."); Sample Ruling at 4 ("I do think there's a larger lesson that's arisen in not just this

the Court has exercised its remedial discretion by (i) dismissing the plaintiff from the case with prejudice, (ii) barring the plaintiff from participating in any recovery from the litigation, (iii) requiring self-reporting of the trading activity to the SEC, (iv) ordering the party to disclose its improper trading in any future application to serve as lead plaintiff, and (v) requiring disgorgement of trading profits.

In the *Netsmart* litigation, a sophisticated hedge fund serving as one of the representative plaintiffs sold stock during the pendency of the litigation. At the time, the plaintiff had received advice from counsel on the likely outcome of the litigation, and counsel's views were informed by the discovery taken in the case. The confidentiality order only contained a use restriction, not an additional trading restriction. The hedge fund consulted with class counsel, who advised that the trade was permissible. Rather than profiting, the hedge fund lost money on the trade. The Court nevertheless imposed sanctions, explaining that because class representatives "act[] as fiduciaries on behalf of others," they cannot come to the Court "as a free agent able to get nonpublic information and make [their] own trading decisions. [They] lose that freedom when . . . [they] sue." Netsmart Ruling I at 14. The Court emphasized that trading based on non-public information obtained through litigation "is just not done," "is just not acceptable," and "is not stuff you mess around with." *Id.* at 13. The Court dismissed the plaintiff from the

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case but out of several recent cases . . . in terms of not trading in securities during the pendency of a representative action . . . ."); Netezza Ruling at 15 ("When you file a suit and you're purporting to represent a class, absolutely there has to be an understanding that you are not free to buy and sell securities in the same way that you were before . . . .").

case with prejudice and required the plaintiff to report the sales to the relevant enforcement unit at the SEC. *In re Netsmart Techs., Inc. S'holders Litig.*, Consol. C.A. No. 2563-VCS (Del. Ch. July 16, 2007) (ORDER).

Likewise, in *Berger*, a representative plaintiff bought shares during the pendency of the lawsuit and while in possession of non-public confidential information, including class counsel's views based on discovery and knowledge of an early settlement proposal from the defendants that class counsel declined. The Court made clear that a representative plaintiff cannot "get access to litigation information that other people don't have and then [trade] at the expense of people in the class whose interest he represents . . . ." Berger Ruling at 59. Rather, "you kind of come in to litigation with that you have; and then if you want to sign up for confidential information, you're going to deal with limitations on your ability to buy and sell." *Id.* at 55-56. The Court dismissed the representative plaintiff who purchased stock from the action with prejudice and precluded him from receiving any recovery from the litigation for shares purchased after the confidentiality order was entered. *See Berger v. Icahn Enters. L.P.*, C.A. No. 3522-VCS (Del. Ch. Nov. 16, 2009) (ORDER); *see also* Benton Ruling at 77 (noting in denying application for preliminary injunction that "it's important that plaintiffs representing classes b[e] very careful about their trading when they have access to confidential information. . . . It's not good policy. You own what you own coming in.").

The Court has reiterated its concerns about trading in other contexts. In *Sample*, after learning that the representative plaintiff sold shares of company's stock after filing its lawsuit and while in possession of non-public information regarding a settlement reached by his counsel, the Court declined to approve the settlement unless the representative plaintiff self-reported to the SEC and disclosed his trading in the notice of settlement. *See Sample v. Morgan*, C.A. No. 1214-VCS, at 8 (Del. Ch. May 14, 2008) (TRANSCRIPT). The Court suggested that the plaintiff relinquish to the defendant company the 1,000 shares that he purchased while in possession of non-public information. *Id.*; *see Sample v. Morgan*, C.A. No. 1214-VCS (Del. Ch. Aug. 5, 2008) (ORDER). In *Netezza*, after plaintiffs' counsel disclosed during the settlement approval hearing that the plaintiffs may have sold their shares after the parties reached settlement, the Court agreed to approve the settlement only if the plaintiffs submitted affidavits detailing any trading during the pendency of the lawsuit and explaining the reasons for each transaction. Netezza Ruling at 14; *see In re Netezza Corp. S'holder Litig.*, Consol. C.A. No. 5858-VCS (Del. Ch. Apr. 13, 2011) (ORDER).

A. Steinhardt

Steinhardt decided to sell Calix common stock short after receiving detailed information from Chen about the ongoing litigation, both in the form of written memos and oral reports. Chen was deeply involved in the case, reviewed Confidential Discovery Material, worked closely with counsel, and received reports on depositions or attended them himself. Information gleaned from Confidential Discovery Material and counsel's litigation assessments permeated Chen's views and informed his communications with Steinhardt. In his interrogatory responses, Steinhardt admitted that his trading decisions were "influenced by Mr. Chen." Basser-Wall Aff., Ex. 8 at 8.

As this Court's prior rulings demonstrate, the fact that a representative plaintiff does not directly have access to confidential information produced in discovery is not the determinative issue. The core problem is simple: When a representative plaintiff and its counsel wield the clout of a class action, gain access to expedited discovery, and pursue a preliminary injunction against a market-moving transaction, the representative plaintiff and its counsel almost invariably acquire non-public information about the transaction that ordinary investors do not have. The plaintiff's lawyer is duty-bound to discuss with her clients important developments and major decisions in the litigation, including whether and on what terms to settle. Counsel's advice necessarily will be influenced by her review of the discovery record and other non-public information, including communications with defense counsel and the content of any settlement offers. Indeed, the most value-relevant information may not be any specific document or information obtained in discovery, but rather counsel's overall sense of how well discovery has gone, whether there is a genuine chance for an injunction, and whether the claims are likely to lead to a favorable litigation outcome or settlement.

This case illustrates the problem. Steinhardt sold Calix short with the benefit of knowledge received from Chen, whose insights in turn were based on discussions with counsel and the discovery record. "[E]verything that [Steinhardt] knew"—including knowledge about the litigation—led Steinhardt to conclude that the Merger would be consummated with no change in price. The reverse example occurred in *Sample*, when the plaintiff learned that his counsel had secured a settlement that would generate additional cash for the class. *Sample v. Morgan*, C.A. No. 1214-VCS, at 5-6 (Del. Ch.

May 14, 2008) (TRANSCRIPT). The plaintiff then bought shares at a price below what the settlement would justify. *See id.* at 10. In both situations, a plaintiff who stepped forward as a fiduciary for the other stockholders used non-public information for personal advantage in securities transactions with members of the class that the plaintiff proposed to represent. Conduct of this nature undermines the integrity of the representative litigation process and is inconsistent with the behavior expected of a self-designated fiduciary.

Steinhardt personally made the decision to sell Calix short. Steinhardt did not make any effort to establish an internal ethical wall or otherwise segregate litigation responsibility from trading responsibility. To suppose that Steinhardt could mentally segregate the knowledge he received from Chen and exclude it from his trading decisions would require "an epistemological leap of heroic proportions." *In re Pennzoil Co. S'holders Litig.*, 1997 WL 770663, at *3 (Del. Ch. Oct. 27, 1997) (rejecting assertion that "'litigation consultants' would be able to 'segregate mentally' confidential financial information when they switch[ed] into their role as 'financial consultants'"); *see* Berger Ruling at 39 (dismissing as "nonsense" the plaintiff's contention "that what he does as a trader and what he does as a plaintiff are separate"). By trading after receiving information from Chen that was derived from Confidential Discovery Material, Steinhardt and the Funds breached their fiduciary obligations as representative plaintiffs and violated both the Use Restriction and the Trading Restriction.

The attempt by Steinhardt and the Funds to step down as proposed class representatives does not moot their past violations. Regardless of whether they continue acting as representative plaintiffs, Steinhardt and the Funds breached their fiduciary duties while serving as self-appointed class representatives. The breach of duty is complete and cannot be undone. So is the violation of the Confidentiality Order.

Consistent with prior rulings, as a remedy for their improper trading, Steinhardt and the Funds are (i) dismissed from the case with prejudice and barred from receiving any recovery from the litigation, (ii) required to self-report to the SEC, (iii) directed to disclose their improper trading in any future application to serve as lead plaintiff, and (iv) ordered to disgorge their trading profits.

First, Steinhardt and the Funds are dismissed from the case with prejudice and barred from participating in any recovery from the litigation. By deciding to sell Calix short, Steinhardt sought to exit his Occam position and accept the benefits of the then-pending Merger. By doing so, he abandoned the class, acquiesced in the Merger, and waived his claims. *See Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 842 (Del. 1987).

Second, Steinhardt and the Funds shall self-report to the Director of the Division of Enforcement of the SEC. *See* Netsmart Ruling II at 34-35. Copies of the self-report shall be filed with the Court and served on all counsel of record. The SEC will then be able to determine whether any further remedial action is warranted.

Third, Steinhardt and the Funds will disclose their improper trading in any future application to serve as lead plaintiff and shall provide the judge with a copy of this decision. *See also Beck v. Atl. Coast PLC*, 868 A.2d 840, 857 (Del. Ch. 2005) (requiring in addition to sanctioning counsel that "in the future, any application by Scott or Roth, or by any lawyer at the firm of Lukins & Annis, for admission pro hac vice shall be accompanied by a copy of this decision"). With the benefit of this information, the judge in the future case will be able to determine whether to allow Steinhardt or the Funds to serve in a representative capacity.

Fourth, Steinhardt and the Funds shall disgorge their gains from trading in breach of their duties and in violation of this Court's Order. *See Kahn v. Kohlberg Kravis Roberts & Co.*, 23 A.3d 831, 837-38 (Del. 2011) (recognizing disgorgement remedy for improper trading by a fiduciary independent of harm to beneficiary).

> It is an act of disloyalty for a fiduciary to profit personally from the use of information secured in a confidential relationship, even if such profit or advantage is not gained at the expense of the fiduciary. The result is nonetheless one of unjust enrichment which will not be countenanced by a Court of Equity.

Oberly v. Kirby, 592 A.2d 445, 463 (Del. 1991); *accord Thorpe v. CERBCO, Inc.*, 676 A.2d 436, 445 (Del. 1996); *In re Tri-Star Pictures, Inc., Litig.*, 634 A.2d 319, 334 (Del. 1993).

To avoid imposing a disproportionate sanction, the disgorgement remedy must be tailored to the wrongful conduct. In theory, Steinhardt and the Funds could be forced to disgorge all profits generated from the 2,014,007 shares of Occam that they effectively sold by shorting 589,097 shares of Calix. When all of these trades were made, Steinhardt and the Funds were serving as self-appointed fiduciaries, operating within the strictures of Confidentiality Order, and receiving information from Chen.

The disgorgement remedy, however, should not encompass profits unrelated to any advantage that Steinhardt and the Funds gained by serving as representative plaintiffs. Steinhardt and the Funds originally acquired nearly all of their Occam shares in January 2009 by purchasing them from Chen at a distressed price. Much of their eventual profits came from the opportunistic purchase and had no connection to the litigation. It would be overly punitive to require Steinhardt and the Funds to disgorge their entire gain as measured by the difference between their original basis and their effective sale price.

It likewise seems overly punitive to require Steinhardt and the Funds to disgorge profits on shares sold after the injunction hearing. The hearing was open to the public and broadcast by Courtroom View Network. At the conclusion of the hearing, I granted the plaintiffs' motion and enjoined the Merger pending the issuance of supplemental disclosures and a deposition of one of the lead bankers from Jefferies. That ruling eliminated Steinhardt's ability to benefit from Chen's insights about the litigation and the potential for an injunction. The ruling also eliminated the last major impediment to closing by limiting the pre-closing remedy to the issuance of supplemental disclosures. It would have been reasonably clear to anyone buying or selling Occam or Calix shares that the Merger was highly likely to close once the supplemental disclosures went out. During the limited post-injunction window when he shorted the bulk of the Calix shares, Steinhardt did not have a meaningful advantage from serving as a fiduciary for the class, and he therefore will not be required to disgorge profits from Calix shares sold after the injunction hearing.

By serving as representative plaintiffs, Steinhardt and the Funds gained access to real-time insights informed by Confidential Discovery Material and counsel's litigation assessments. Based in part on this information, Steinhardt and the Funds decided to abandon their challenge to the Merger and exit their Occam position in a manner designed to capture the arbitrage spread between Occam and Calix. The disgorgement remedy should target that slice of profits.

Steinhardt and the Funds generated total proceeds of $1,886,751.98 from short selling 112,014 shares of Calix stock before the injunction hearing:

Date	**Shares**	**Price**	**Proceeds**
12/28/2010	60,000	$16.61	$996,715.11
12/29/2010	3,871	$16.97	$65,689.75
12/30/2010	12,055	$17.18	$207,073.66
12/31/2010	25,352	$17.23	$436,696.00
1/18/2011	136	$16.83	$2,288.49
1/19/2011	10,000	$16.82	$168,197.15
1/20/2011	600	$16.82	$10,091.82
Total:	112,014		$1,886,751.98

Having decided not to use Steinhardt and the Funds' historical basis in their Occam shares, I need implied purchases against which to measure profits. To model the arbitrage spread, the implied purchases should be of Occam shares rather than Calix. At the Merger exchange ratio of 0.2925 Calix shares for each Occam share, the 112,014 Calix shares equate to 382,954 Occam shares. This figure temporarily ignores the additional Merger consideration of $3.8337 per Occam share in cash.

Ordinarily, a trader capturing a merger arbitrage spread would trade in both the acquirer's and target's shares (or related options) simultaneously. Steinhardt and the Funds, however, already owned their Occam shares. To focus on the merger arbitrage opportunity while excluding gains from the distressed-sale purchase, I deem Steinhardt and the Funds to have bought the 382,954 Occam shares in equal increments across the trading days running from October 6, when Steinhardt and the Funds filed the current action and assumed their fiduciary mantle, through November 11, the day before the Confidentiality Order went into effect and imposed the Use and Trading Restrictions. By spreading the deemed purchases equally over this period, I avoid giving disproportionate emphasis to the price on any particular date.

As the price for each deemed purchase, I use the market low on that day. "Delaware law dictates that the scope of recovery for a breach of the duty of loyalty is not to be determined narrowly." *Thorpe*, 676 A.2d at 445. As recently re-affirmed by the Delaware Supreme Court, Delaware's disgorgement remedy rests upon "a wise public policy that, for the purpose of removing all temptation, extinguishes all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation." *Kahn*, 23 A.3d at 840 (quoting *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939)). Although it would be improbable (bordering on impossible) for even a legendary trader like Steinhardt to maximize his potential profit by buying at precisely the market low each day, the faithless fiduciary must shoulder the burden of uncertainty, not his innocent beneficiaries. *Cf. Duncan v. Theratx, Inc.*, 775 A.2d 1019, 1023-24 (Del. 2000) (measuring damages where a party wrongfully deprived another of the ability to sell shares by subtracting the average price during a reasonable period after reinstatement of the ability to sell from the highest intermediate value during a reasonable period after the ability to sell was suspended); *Paradee v. Paradee*, 2010 WL 3959604, at *13 (Del. Ch. Oct. 5, 2010) ("Where a party has wrongfully deprived another of the ability to sell shares, damages are measured using the highest intermediate value of the shares less the value at the time of judgment.").

This approach results in the following deemed purchases:

Date	**Shares**	**Price**	**Basis**
11/11/2010	14,183	$7.36	$104,386.88
11/10/2010	14,183	$7.33	$103,961.39
11/9/2010	14,183	$7.30	$103,535.90
11/8/2010	14,183	$7.25	$102,826.75
11/5/2010	14,183	$7.27	$103,110.41
11/4/2010	14,183	$7.36	$104,386.88
11/3/2010	14,183	$7.35	$104,245.05
11/2/2010	14,183	$7.36	$104,386.88
11/1/2010	14,183	$7.31	$103,677.73
10/29/2010	14,183	$7.29	$103,394.07
10/28/2010	14,183	$7.30	$103,535.90
10/27/2010	14,183	$7.32	$103,819.56
10/26/2010	14,183	$7.39	$104,812.37
10/25/2010	14,183	$7.45	$105,663.35
10/22/2010	14,184	$7.36	$104,394.24
10/21/2010	14,184	$7.32	$103,826.88
10/20/2010	14,184	$7.36	$104,394.24
10/19/2010	14,184	$7.35	$104,252.40
10/18/2010	14,184	$7.47	$105,954.48
10/15/2010	14,184	$7.43	$105,387.12
10/14/2010	14,184	$7.42	$105,245.28
10/13/2010	14,184	$7.55	$107,089.20
10/12/2010	14,184	$7.44	$105,528.96
10/11/2010	14,184	$7.45	$105,670.80
10/8/2010	14,184	$7.30	$103,543.20
10/7/2010	14,184	$7.29	$103,401.36
10/6/2010	14,184	$7.50	$106,380.00
Total:	382,954		$2,820,811.28

The final step is to deal with the cash portion of the Merger consideration. When Steinhardt covered his short positions with Calix shares received in the Merger, he got to keep the portion of the Merger consideration paid in cash. Put differently, after the Merger announcement, Occam's trading price reflected the expectation that each Occam share would be converted into the right to receive both 0.2925 shares of Calix stock and $3.8337 in cash. To force disgorgement of the share-related spread on an apples-to-apples basis, the cash consideration of $1,468,130.75 tied to 382,954 Occam shares must be backed out. This can be accomplished either by adding the cash consideration to the Calix sale proceeds or subtracting the cash consideration from the deemed purchase price. Following the latter course and deducting $1,468,130.75 from $2,820,811.28 results in an implied basis of $1,352,680.53 for the right to the equity portion of the Merger consideration represented by the Occam shares, which was the underlying property right in Steinhardt's arbitrage play.

Deducting the implied basis from the actual sales proceeds generates a disgorgement amount of $534,071.45. If the same methodology were used for all of the sales of Calix stock, including those post-dating the injunction hearing, the total disgorgement amount would be $3,477,534.97. Steinhardt and the Funds will disgorge $534,071.45 as a sanction for their improper trades.

B. Chen

Chen's trades were materially different from Steinhardt's. Chen's sales of 31,000 shares of Occam stock between October 29 and November 2, 2010 were not improper. Chen convinced me that he sold shares to generate liquidity before his ability to trade became limited. The defendants had not yet produced any non-public information, and the Confidentiality Order had not yet been entered. Chen therefore did not possess any non-public information that would have given rise to a conflict with the class he had volunteered to represent, and the Use Restriction and Trading Restriction were not yet in place. Chen's sales of a small fraction of his Occam holdings do not undercut his litigation position or suggest fiduciary misconduct.

Chen's sale of 2,500 shares on January 25, 2010 also was not improper. Despite the defendants' vigorous attacks on Chen's credibility, I am convinced that the sale was an unintentional "fat-finger" error. Because of the small size of the trade and its inadvertence, it would be inequitable to sanction Chen. In addition, the January 25 trade came on the heels of preliminary injunction hearing on January 24, which eliminated the principal benefit Chen obtained from accessing Confidential Discovery Information.

I am more troubled by Chen's decision to continue providing Steinhardt with written and oral updates on the litigation despite knowing that Steinhardt was shorting Calix in violation of the Use and Trading Restrictions. Although I have concerns about Chen's role in Steinhardt's short-selling, Chen testified credibly during the evidentiary hearing that he advised Steinhardt not to trade. Steinhardt, however, did what he wanted to do. Tr. 76 ("Michael does what he wants to do."). Moreover, the relationship between the two men was such that Chen could not realistically do more. As Chen explained, "[y]ou have to remember that he is the legendary hedge fund investor and, you know, when there is yelling, it usually goes from his direction to my direction, not the other way . . . ." Tr. 77.

Chen has amassed extensive knowledge about Occam and the Merger. He has proven himself to be a highly motivated and effective representative plaintiff. To sanction Chen and remove him from the litigation would inflict significant harm on the class. Chen committed an error of judgment by continuing to communicate with Steinhardt, but I have addressed the harm caused by that error by imposing a remedy on

Steinhardt, the primary wrongdoer. Chen's involvement does not warrant an additional sanction that would serve primarily to penalize the class.

III. CONCLUSION

For the foregoing reasons, the motion for sanctions is granted as to Steinhardt and the Funds but denied as to Chen. I encourage the parties to double-check my math and confer regarding how the funds should be handled. If administratively feasible, the funds could be distributed to the class now. Alternatively, the funds could be held in escrow pending the outcome of this proceeding and allocated as part of any future remedy. Because former holders of Occam shares owned less than 20% of Calix's shares immediately after closing, I am not inclined to award the disgorged funds to Calix as a proxy for the class; however, there may be other possibilities. After conferring, the parties shall submit an implementing order.