Upgrading our article from the Third/Fourth Quarter 2005 Securities Litigation Newsletter, on March 21, 2006, the Supreme Court ruled in the Dabit case, resolving a split between the Second and Seventh Circuits over the scope of the Securities Litigation Uniform Standards Act (“SLUSA”) less than a year after its groundbreaking loss causation decision in Dura Pharmaceuticals v. Broudo. At issue in Dabit was whether SLUSA preemption applies to so-called “holders” claims, brought by those whose purported injury stems from their decision to retain—rather than to buy or sell—their allegedly overvalued securities.

The Supreme Court’s unanimous ruling in Dabit is noteworthy in two respects. First, it closes a loophole through which plaintiffs’ counsel attempted to undermine the uniformity imposed by Congress via the Private Securities Litigation Reform Act (“PSLRA”) and SLUSA. Second, it represents a clear victory for the Seventh Circuit’s Judge Frank H. Easterbrook, whose spirited opinion in Kircher v. Putnam Funds Trust (“Putnam Funds II”) sharply criticized the Second Circuit’s interpretation of the Supreme Court’s landmark decision in Blue Chip Stamps, which limited private 10b-5 actions to situations in which the plaintiffs were fraudulently induced to purchase or sell securities.

Interestingly, the Dabit ruling resolves only one of the two SLUSA-related splits between the Second and Seventh Circuits. As discussed in our first article on this topic, Judge Easterbrook’s decisions in the Putnam Funds litigation opened a “double-split.” While Dabit answered the question of whether SLUSA preempts state law claims in cases where the plaintiff neither purchased nor sold covered securities, it does not resolve the second dispute: whether a district court’s decision to remand an action removed to federal court under the auspices of SLUSA is appealable. The Supreme Court will consider this second issue in a separate matter, scheduled for oral argument on April 24, 2006.

In Dabit, the Second Circuit found that the claims asserted by “holders” do not allege fraud “in connection with the purchase or sale” of securities, and thus fall outside SLUSA’s ambit. The Second Circuit acknowledged, but ultimately rejected, Merrill Lynch’s argument— bolstered by an SEC amicus brief—that the phrase “in connection with the
Lessons to Learn from *SEC v. KPMG*: The Contours of Auditors’ Liability for Securities Fraud and Under Section 10A

Peter W. Devereaux and Robert J. Malionek

The lines between primary and secondary liability for individual auditors for alleged violations of federal securities laws were clarified by a recent decision in the U.S. District Court for Southern District of New York. In a civil action filed by the SEC against individual audit partners, the Court granted, in part, the individual auditors’ motions for summary judgment. *Securities and Exchange Comm’n v. KPMG LLP*, 412 F. Supp. 2d 349 (S.D.N.Y. Jan. 13, 2006) (Cote, J.) (amending opinion at 2005 WL 3540202 (Dec. 28, 2005)). In doing so, Judge Cote made several important holdings. First, primary liability under Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act for audit reports only applies to those who were “sufficiently responsible for the statement—in effect, caused the statement to be made—and knew or had reason to know that the statement would be disseminated to investors.” In so holding, the Court said that “[t]his formulation covers a narrower scope of conduct, and therefore a smaller class of defendants, than would be implicated by the ‘substantial participation’ test rejected by the Second Circuit in Wright.” As such, the Court granted summary judgment to the concurring partner on the claim of primary liability, holding that under the evidence presented, the role of the concurring partner did not meet this test for the audit reports at issue. Rather, the Court held, the concurring partner could only be held liable, at most, under Section 20(e) for aiding and abetting the securities law violations of others.

Second, in connection with the Section 20(e) claim against the concurring partner, the Court held that liability for aiding and abetting only attaches to those with actual knowledge. The Court rejected the notion that recklessness was sufficient.

Third, the Court held that under the Reform Act, which has since been amended by the Sarbanes Oxley Act (“SOX”), liability under Section 10A lies only with the audit firm responsible for an audit, not individuals in the firm. The effect of this holding is limited to conduct prior to the enactment of SOX (July 30, 2002), which explicitly provides that Section 10A liability may attach to both firms and individuals. 15 U.S.C. §§ 78j-1(b), 7201(5) & 7201(11). However, in actions involving pre-SOX conduct, the holding could be an important limitation on enforcement action liability.

Lastly, auditors should take special note that the Court saw fit to rely not only on AICPA professional standards to describe the contours of an auditor’s role in an audit (and thus responsibilities under the securities laws), but also on an audit firm’s internal audit manual (and indeed, sometimes to the exclusion of the professional standards themselves).

Background

This enforcement action arose out of the financial restatements of Xerox Corporation in 2001 and 2002. At the heart of the restatements were issues with respect to the company’s accounting treatment of bundled leases and reserves. Judge Cote’s analysis of the complex application of GAAP to Xerox’s transactions, as well as an auditor’s responsibilities under GAAS, was influenced by her exhaustive discussion of these principles and (Continued on Page 3)
standards in her recent decision in

The SEC brought various securities and Section 10A claims against KPMG—Xerox’s external auditor during the four years at issue—and five KPMG partners. After KPMG settled in 2004 and one partner settled in 2005, the SEC continued its litigation against the four remaining partners: three engagement partners who supervised different year-end audits from 1997-2000 and the concurring partner during all four years. Against the four, the SEC alleged claims for: (1) violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act; (2) aiding and abetting violations of Section 10(b) of the Exchange Act; and (3) violations of Section 10A of the Exchange Act. The individuals filed motions for summary judgment, which were addressed in the Court’s opinion.

**Primary Liability vs. Liability for Aiding and Abetting**

The individual auditors argued that, because the audit reports were issued in the name of KPMG (as required by GAAS), they could not face liability as primary violators of Section 10(b) or Section 17(a). Rather, they argued, they could only face secondary liability, i.e., liability for aiding and abetting. The SEC—and not private litigants—may bring aiding and abetting claims, but only through the use of Section 20(e) of the Exchange Act, which provides that “any person that knowingly provides substantial assistance to another person committing securities fraud will be jointly and severally liable.”

The Court recognized that the line between primary and secondary liability is gray, and found Second Circuit case law to be less than helpful. In one formulation of the standard—the one advanced by the SEC against the individuals—the Second Circuit held that primary liability attaches not only to those who made the misrepresentations “but also on those who had knowledge of the fraud and assisted in its perpetration.” *See SEC v. First Jersey Secs., Inc.*, 101 F.3d 1450, 1471 (2d Cir. 1996). But the court found conflicting guidance from *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998), which held that the accountants in that case were “secondary actors who may no longer be held primarily liable under Section 10(b) for mere knowledge and assistance in the fraud.” The holding in *Wright* hinged upon the premise that, in order to give teeth to the element of a Section 10(b) claim that the claimant relied upon a misrepresentation, primary liability must be reserved for those who actually made the misrepresentation, i.e., the misrepresentation must be attributed to the defendant. This, indeed, was a basic tenet of the Supreme Court’s holding in *Central Bank of Denver*,

Auditors should take special note that the Court saw fit to rely not only on AICPA professional standards to describe the contours of an auditor’s role in an audit (and thus responsibilities under the securities laws), but also on an audit firm’s internal audit manual (and indeed, sometimes to the exclusion of the professional standards themselves).
In January, in one of the first significant enforcement pronouncements since Chairman Christopher Cox assumed leadership, the Securities and Exchange Commission moved to quiet what has been a controversial topic by issuing a statement on how it will impose civil penalties on corporations. SEC Press Release 2006-4, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2005) (the “Statement” or “Corporate Penalties Statement”). The Statement represents the Commission’s attempt “to provide the maximum possible degree of clarity, consistency, and predictability in explaining the way that its corporate penalty authority will be exercised.” The Commission should be applauded for its latest effort to provide transparency to the enforcement process and to articulate its views on when a penalty is appropriate against a public company. However, for those directors and senior officers of public companies facing the possibility of an SEC enforcement proceeding, and for the lawyers who counsel them, some uncertainties remain.

A Brief History of the SEC’s Corporate Penalty Power

Prior to 1984, the SEC relied almost exclusively on equitable remedies to enforce the securities laws. These remedies included civil injunctions, relinquishment of illegal profits (disgorgement), bars or suspensions of individuals from serving as a corporate officer or director, and various required actions such as audits, accountings, or special supervisory arrangements.

Since 1984, Congress has progressively granted the SEC greater authority to impose civil penalties. These grants of authority have followed increasing public demands for securities regulation. The first major change came as a result of Congress’ belief that the existing arsenal of sanctions was insufficient to deter insider trading. The result was the Insider Trading Sanctions Act of 1984, which authorized the SEC to seek civil penalties of up to three times the profit gained or loss avoided by an individual who commits insider trading.

The next and most significant congressional grant of authority was a reaction to perceived fraud during the late 1980s in the over-the-counter market for thinly traded securities. Congress enacted the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (the “Remedies Act”), which, among other new remedies, gave the SEC authority generally to obtain money penalties from corporate issuers in enforcement cases. The legislative history of the Remedies Act sets forth six factors for the SEC to consider before imposing civil money penalties against a public company: (1) whether the conduct involves fraud, deceit, manipulation, or deliberate or reckless disregard of regulatory requirements; (2) the harm to others from the violation; (3) the extent of any unjust enrichment or any restitution; (4) any history of securities law recidivism; (5) deterrence of the individual and others; and (6) "such other matters as justice may require." The latest grant of authority in this area came after the massive corporate scandals beginning with Enron. Congress passed the Sarbanes-Oxley Act, and specifically Section 308.

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(the "Fair Funds" provision), which permits the SEC to take penalties paid by defendants and add them to disgorgement funds for the benefit of victims such as shareholders. Previously, penalties collected in SEC enforcement actions went to the U.S. Treasury. Because the Fair Funds provision allows corporate penalties to be distributed to injured shareholders, the provision served as one justification for the Commission imposing larger civil penalties on public companies than ever before.  

The Controversy Over Corporate Penalties After Sarbanes-Oxley

Civil penalties levied against public corporations in enforcement proceedings brought by the Commission have grown dramatically in amount and in frequency after the 2002 passage of the Sarbanes-Oxley Act. Since then, the SEC has obtained billions of dollars in penalties, the bulk of which were imposed on corporations in settled enforcement actions. The largest pre-Sarbanes-Oxley penalty imposed by the SEC against a public company that was not a regulated financial institution was the $10 million penalty imposed against Xerox in April 2002. After Sarbanes-Oxley, corporate penalties against non-regulated-entity public companies have become far larger—including penalties against Qwest Communications for $250 million, Time Warner for $300 million, and the record-setting penalty against WorldCom for $750 million. Large corporate penalties also increased in frequency—according to one report, in 2005, there were 15 fines of $10 million or more.  

Almost two years after passage of the Sarbanes-Oxley Act, Stephen M. Cutler, then-Director of the Commission’s Division of Enforcement, stated that the paradigm shift “from a regime in which monetary penalties were imposed only rarely to one in which large penalties seem to be part of virtually all significant settlements” represented an “evolution, if not revolution” in the Commission’s thinking on enforcement sanctions.  

But this increase in the size and frequency of corporate penalties did not meet universal acclaim, even within the Commission itself. According to the Statement, “within the Commission itself a variety of views [on corporate penalties] have heretofore been expressed, but not reconciled.” Disagreements about such penalties may have caused a deadlock among Commissioners in certain contemplated enforcement actions.  

Critics of corporate penalties argued that exacting large penalties from a corporation, rather than the culpable individuals, can have the perverse effect of harming shareholders twice—when the fraud is first uncovered and the stock price declines, and then again when the corporation pays a significant penalty. For this reason, Commissioner Paul Atkins summarized his view that the better course is to pursue individuals responsible:

If you’re a shareholder who held shares through [a financial fraud] and are still holding the shares now, your shares are worth less, but now we’re taking money from the company to give only pennies on the dollar back to you. That hurts the company’s ability to grow and ultimately hurts shareholder value.

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In Homestore, Inc. v. Tafeen, No. 223,2005, 2005 WL 3091887 (Del. Nov. 17, 2005), the Delaware Supreme Court addressed a corporation’s duty to advance legal defense costs to former corporate fiduciaries under mandatory advancement provisions of corporate bylaws. The case, which upheld strict enforcement of mandatory advancement provisions, provides a useful reminder of the care that companies, directors and officers, must take to balance appropriately two considerations: a corporation’s desire to exercise discretion in advancing fees, and considerations of a director/officer’s ability to defend legal challenges should they arise.

Court Required Homestore to Indemnify/Advance Fees to Former Executive

The Tafeen case arose out of a former officer’s demand for advancement of legal defense costs incurred during securities enforcement actions, criminal investigations, and private litigation concerning alleged accounting irregularities at Homestore, Inc. Peter B. Tafeen had been a senior officer of Homestore and was allegedly a central figure in a scheme that allowed Homestore to overstate revenues. In the wake of the investigations, Tafeen left the company and was eventually indicted along with the corporation’s former CEO. Under the circumstances, Tafeen’s posture toward Homestore became adversarial, while at the same time Tafeen was forced to incur millions of dollars in legal fees to defend against the litigation and investigations. Homestore, which claimed to have paid Tafeen $15 million in the recent past, opposed paying Tafeen anything more in light of the harm he allegedly did to the company and denied Tafeen’s request for advancement of legal fees. Tafeen, claiming an absolute right to advancement under the corporation’s bylaws, sued in Delaware Chancery Court to enforce the bylaws provision. Tafeen prevailed in the lower court and obtained a judgment requiring Homestore to pay to him about $4 million in legal fees and interest to the date of the judgment. The court also issued an injunction requiring Homestore to advance legal fees to Tafeen in the future. The corporation appealed to the Delaware Supreme Court.

Rejecting a variety of legal and equitable defenses advanced by Homestore, the Supreme Court reaffirmed certain truths about indemnification and advancement provisions in corporate governance documents. Most importantly, the court reaffirmed the rule that where the bylaws mandate that the corporation “shall” indemnify and advance legal fees and expenses to directors and officers, the mandatory provision will be enforced strictly. Where the corporation’s governing documents provide mandatory advancement of defenses fees before final determination of the director or officer’s right to indemnification, the court held that advancement obligations must be met, subject only to the statutory right to recover such advances if the individual is later shown to have acted in bad faith. The court held that the public policy benefits that indemnification provisions are designed to provide “will only be achieved if the promissory terms of advancement contracts are enforced by courts even when corporate officials . . . are accused of serious misconduct.” Thus, despite a

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number of creative arguments to avoid advancement of fees, Homestore was stuck with the tab for defending a former officer whose conduct it bitterly resented and who it believed had done great damage to the corporation (all while being compensated lavishly).

The Tafeen case might encourage a corporation to reserve greater flexibility for itself in its bylaws. The Tafeen court pointed out that a corporation does not have to make indemnification or advancement provisions mandatory, and can reserve the right to determine whether to indemnify and/or advance defense costs on a case-by-case basis. Yet with greater flexibility come significant potential disadvantages which may arise at precisely the time when a corporate fiduciary and the company itself need the protection of a well-funded legal defense the most.

As a threshold matter, the advancement of legal fees and expenses may mean the difference between an officer’s or director’s ability to mount a defense in civil litigation or government investigations and the need to acquiesce helplessly, even in cases where the officer or director was not involved in misconduct. The government’s resources, and the financial demands of a reasonably corresponding defense, can be staggering from an individual’s standpoint. In the Tafeen case, for example, defense costs were almost $4 million and rising at the time of the case. Indeed, defense against any one investigation or proceeding is demanding enough, but the multi-agency enforcement approach often taken by the government (to say nothing of the private litigation that inevitably ensues) makes any individual’s defense an inherently expensive proposition. It is for this important reason that the Delaware courts have recognized that, as the Tafeen court put it, “[a]dvancement is an especially important corollary to indemnification… [because it] provides corporate officials with immediate interim relief from the… significant ongoing expenses inevitably involved with investigations and legal proceedings.” Indeed, not only the Tafeen court but other courts and commentators as well have recognized that a meaningful opportunity for appropriate indemnification and advancement of fees is a critical tool in recruiting willing directors and officers of high quality to corporate service.

The Tafeen case clearly illustrates the hazards of front-end commitment through mandatory indemnification and advancement provisions. A corporation, particularly one that has been weakened by financial or other improprieties, may find itself paying millions to fund the defense of the very executives and/or directors who created the dilemma for the company in the first place—at the very point when it may be least able to afford those expenditures from a reputational, morale or even financial perspective. Moreover, even a director or officer who is ultimately adjudged to have acted in bad faith and therefore is obligated to repay amounts advanced could lack the financial resources to make good on that obligation later down the road. And even if insurance pays the cost of such advancement, complex questions of allocation and entitlement diminish the corporation’s ability to defend itself and/or satisfy its own liabilities, due to substantial obligations to directors and officers.

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Against this backdrop, some have suggested that corporations adopt only permissive indemnification and advancement provisions, preserving the right to decide to what degree it wishes to protect a director or officer in legal jeopardy as events unfold. They contend that advantages include (1) the greater likelihood of inducing the individual’s cooperation with the company’s defense; (2) preservation of corporate assets; and (3) the opportunity to show cooperation with the government by withholding support from individuals who resist acknowledging their own responsibility for wrongdoing. Some have even suggested that if and when an advancement of fees is made, corporations should not only get the customary undertaking by the director or officer to repay amounts advanced if determined not to be entitled to indemnification as a matter of law, but should actually require the fiduciary to post security in advance for the undertaking. These points have their merit, and certainly deserve consideration by boards of directors—but other factors deserve close scrutiny, as well.

Corporations with bylaws permitting but not requiring indemnification and advancement of fees may find that the discretion they intended to preserve is constrained in unexpected ways. In particular, they run the risk that government agencies (or even activist shareholders) might exert pressure on boards to deny indemnification in circumstances where the board would afford the director or officer an opportunity to defend himself or herself meaningfully.

This circumstance could easily arise (and has arisen) in heavily regulated industries, in particular, in which allegations of impropriety may concern complex accounting, scientific, engineering, or other technical issues. In these instances, ultimate liability—and thus indemnification of the director or officer—may turn on hotly contested interpretations of governing rules, often with little or no direct precedent. Most boards would consider that a director or officer—particularly one whose service has otherwise been exemplary or even simply honorable—should have a full opportunity to defend himself as he sees fit against legal jeopardy arising from such disputes. This would be especially true in cases where the corporation could choose whether to accept culpability or defend its conduct, and could use personnel actions against individuals (including directors and officers) as a tool to serve corporate interests if settlement with the government is desired.

Nevertheless, in several highly publicized (and unpublicized) situations in recent years, government enforcement officials have used their persuasive leverage to deny individuals permissive indemnification and thus the resources needed to challenge government investigations and also punished corporations who have granted permissive indemnification to those defending themselves in enforcement actions. Examples include the Securities and Exchange Commission’s (SEC’s) $25 million penalty against Lucent Corporation for “lack of cooperation” with the SEC’s enforcement efforts based, in significant part, on its discretionary decision to advance legal fees to employees who were preparing to contest, rather than settle, the charges against them. Such pressure has exerted a chilling effect on discretionary indemnification, and takes only a subtle suggestion

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or question by government enforcement officials to apply with great force. Similar pressure is frequently exercised by regulators (and increasingly shareholders) in scrutinizing any other kind of discretionary payments to executives where the corporation is under the legal microscope. In short, because government regulators make cooperation with their efforts a touchstone of the company’s mitigation of any wrongdoing, it lies within their power to define “cooperation” to require withholding permissive indemnification to an individual who puts up any kind of spirited, non-settling defense.

Taking the Fork in the Road Before You Get There

Thus, in today’s climate, a serious risk for a corporate board to consider is the risk that it may not be free to indemnify and advance defense costs in circumstances where it has tried to retain discretion and would otherwise do so. Such boards should attend to their governance procedures, contracts and insurance arrangements before trouble starts to ensure that corporate fiduciaries have a meaningful opportunity to defend themselves if something does go wrong, by taking the following steps:

• Any corporation opting for mandatory protection should ensure that its bylaws provide in mandatory language for indemnification and advancement of fees to directors and officers to the maximum extent permitted by the law of the state of incorporation.
• They should also include this right in contracts with directors and officers if they seek to assure those individuals that they will have a mandatory advancement right throughout their service regardless what future boards or shareholder activists may do. Establishing the right to indemnification and advancement of fees by contract is also the appropriate vehicle for securing such rights for key employees who are not officers, if the corporation desires. It is simply much harder to identify and protect a changing list of key individuals by bulk treatment in corporate governance documents, and contracts offer a superior vehicle tailored to this purpose.

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Recent and Upcoming Seminars and Speaking Engagements

- Latham attorneys led breakfast seminars across the US on the events that are shaping the 2006 Proxy Season, the latest new revisions to the SEC executive compensation rules, and best practices as part of the General Counsel Forum: “Critical Issues for the 2006 Proxy Season: Majority Voting and Executive Compensation Proposals, New SEC Rules and Best Practices”. Speakers included Jim Barrall (LA), Rob Burwell (SD), Steven Della Rocca (NY), Scott Haber (SF), Scott Hodgkins (LA), Peter Kerman (SV), Chuck Nathan (NY), Charles Ruck (OC), Faye Russell (SD), Scott Shean (OC), Dave Barby (OC), and Bradd Williamson (NY), Scott Wolfe (SD) and Joe Yaffe (SV). The events were held February 15—17 in multiple locations across the US.

- Partners Jamie Wine (LA) and Pamela Palmer (LA) presented the “Roles and Exposures of the Gatekeepers: Auditors, General Counsel, and Audit Committees” to the Fraud Section of the California Society of CPAs on February 21.

- Partner Max Wilmanns (HH) and of counsel Finn Zeidler (FF) presented “The Federal Government’s Ten Steps Towards the Improvement of Investors’ Protection in the German Capital Markets” at Latham’s “Legal Update Seminar” in Frankfurt and Hamburg, Germany, on March 1 and March 8.

- Partner David Brodsky (NY) spoke on “Evolving Roles of Audit Committees, In-House Counsel and Compliance in Fraud Risk Management,” and partner Paul Dawes (SV) was a panelist discussing “Dealing with Whistleblowers in Your Organization” during the American Conference Institute (ACI)—National Forum on Fraud Risk Management: Preventing, Detecting and Responding to Fraud and Misconduct on February 28 in New York.

- Partners David Brodsky (NY) and Laurie Smilan (VA) were featured speakers at the Securities Industry Association Compliance and Legal Division Annual Seminar, March 19-22 in Hollywood, Florida. Topics included the Challenges of Electronic Discovery, and Major Liabilities in Civil Litigation—Particularly Focused On Settlements. They were joined by partners Bill Baker (DC) and Larry West (DC).

- Latham hosted a lunch briefing for the Association of Corporate Counsel—San Diego Chapter featuring a discussion of issues relating to how in-house counsel and compliance personnel should prepare for and respond to a crisis situation. Topics discussed included compliance and contingency planning, legal and regulatory requirements and practical advice on how to cope with and manage through a crisis situation. Crises addressed included accounting restatements, internal investigations and whistleblower complaints, stock delisting proceedings, and governmental or criminal investigations. The March 23 panel included partner Tom Edwards (SD).

- Partner Mark Gerstein (CH) served as Vice Chair for the 26th Annual Ray Garrett Corporate and Securities Law Institute sponsored by Northwestern University School of Law and spoke on a panel entitled “Dealing with Significant and Activist Stockholders: Rights, Duties, and Strategies.” The seminar addressed issues such as proposed disclosure rules for executive compensation, implications of the new reform process for securities offerings and dealing with activist stockholders. Partner John Huber (DC) chaired the session “Practical Tips for Addressing Issues: From Start to Finish and Everything in Between” and partner Peter Kerman (SV) covered “Corporate Lawyers: Professional Responsibilities and Liabilities.” The conference took place May 4-5 in Chicago.

- Latham co-sponsored the 2006 SEC Conference on Sarbanes-Oxley 404: Practical Guidance for Implementing Internal Control Reporting Requirements for European Companies hosted by the Center for Professional Education (CPE). London partner Alex Cohen (LO) was a featured speaker at this conference, May 11-12 in Amsterdam, The Netherlands.
The Role of Insurance

Many of the risks identified above can be addressed, at least in part, through insurance. Pitfalls abound, however. In the relatively recent past, policies that provided coverage for the corporate entity, and for its directors and officers, under a single cap on liability were deemed sufficient protection and directors and officers assumed, without detailed inquiry, that these policies would protect them fully in the event of an investigation or litigation. Although they will not be discussed in detail here, examples of issues the board should consider include the following:

• Limit the applicability of exclusions from coverage. Some policies are void for the entire covered group of fiduciaries if any misrepresentation has been made in securing them. If possible, the policies procured for directors and officers should provide that this exclusion applies only to such officers or directors who personally make material misrepresentations in the policy application. Otherwise, there is a risk that an individual’s misdeeds may vitiate the policy protections when they are most needed.

• Ensure that exclusions for certain kinds of individual misconduct (which all policies have) apply only after final adjudication, rather than permitting the insurance company to deny coverage and defense costs based upon a threshold inquiry and determination. These “final adjudication” clauses make the insurance company’s obligation to shoulder defense costs more meaningful by clarifying the absence of any opportunity for the insurer to make its own factual determination before the defense has been fully made on behalf of the insured fiduciary.

• Consider including “Side A” coverage in the company’s coverage package, by which directors and officers are direct insurance beneficiaries with their own individual rights to claim coverage if they are not indemnified by the corporation. Such coverage may have many variations, and if purchased for directors and officers independently of any coverage that would reimburse the corporation for indemnifying them, may be able to avoid issues that would arise in adverse circumstances such as corporate bankruptcy.

• Consider insurance policies which provide a “tail” beyond the term of the policy period itself, as most D&O policies are of the “claims made” variety.

In summary, even where the corporation and/or its insurance policy offers significant resources which might be available to defend a director or officer who suddenly faces legal exposure, it increasingly requires substantial forethought by the company, at the board level, to protect its fiduciaries in advance of the need to apply those resources. While there may be legitimate reasons for particular corporations to decide to retain flexibility, they should at least be cognizant that that flexibility may translate to weakness when they most need to protect their directors and officers against potential jeopardy.

(Endnotes)

1 Edward J. Shapiro is a partner in Latham & Watkins’ Washington DC office.
On December 21, 2005, the German Criminal Supreme Court established criteria for determining when the approval of corporate executives’ bonuses can be considered a criminal breach of fiduciary duty. The ruling came in Mannesmann, a case concerning bonuses paid to Mannesmann AG’s board members in connection with the company’s initially hostile takeover by Vodafone Airtouch plc (“Vodafone”). Vodafone paid a record sum of €178 billion to acquire Mannesmann, historically a German steel company that successfully expanded its business into mobile telecommunications.

The takeover by Vodafone became the subject of a criminal action when a number of Mannesmann’s former board members and executives announced that they had received appreciation awards and severance payments of approximately €60 million, an unusually high amount by German standards. The government filed charges claiming that some of Mannesmann’s supervisory board members breached their fiduciary duty because they knew that Mannesmann AG did not benefit from granting these after the fact appreciation awards and were “useless” for the company. The court held, however, that risky entrepreneurial decisions can only be punished if there is a serious breach of fiduciary duty. The court determined that such a serious breach of fiduciary duty had not occurred.

The Criminal Supreme Court’s Decision

The Criminal Supreme Court reversed the District Court’s acquittal, remanding the case and ordering the trial court to conduct an entirely new trial. The court held that members of the supervisory board have to preserve the assets of the corporation and prevent hardships for the corporation, making it imperative to refrain from all actions that will lead to a sure financial disadvantage.

The Criminal Supreme Court distinguished three types of deferred extraordinary compensation for contractually owed services. In

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the first, the Court held that if the employment contract provides for a variable compensation component (i.e., a premium or bonus payment) that is tied to the success of the corporation, granting deferred extraordinary compensation is permissible, provided that the amount is reasonable. For the second type, the Court held that even if the employment contract does not provide for payment of an appreciation award, such payment is permissible if the resulting decrease of the corporation's assets is proportional to other gains incurred by the deferred extraordinary compensation. Taking the incentive of extraordinary compensation for future board members into consideration, the Criminal Supreme Court stated that deferred compensation for outgoing executive board members may be permissible, if such compensation is reasonable. In the final form of deferred extraordinary compensation, the court held that if the employment contract does not pay a deferred appreciation award and the supervisory board grants the award anyway (even though the corporation cannot incur a future benefit from such an award), the corporation's assets have been wasted and is tantamount to a breach of fiduciary duties. The court further stated that it is irrelevant whether the executive's total compensation can be viewed as reasonable in light of his or her performance and the financial situation of the corporation.

The Criminal Supreme Court did not agree with the defendants' argument that Vodafone, as the new owner of Mannesmann, consented to the payment of the appreciation awards. The court held that Vodafone's consent could not relieve the supervisory board members of their fiduciary duty being that at the time payments of appreciation awards were made Vodafone only owned 98.66 percent of the shares and, therefore, was not the new owner of Mannesmann, but only a majority shareholder.

The Court held that if the employment contract does not pay a deferred appreciation award and the supervisory board grants the award anyway (even though the corporation cannot incur a future benefit from such an award), the corporation’s assets have been wasted and is tantamount to a breach of fiduciary duties.

The Criminal Supreme Court expressly rejected the District Court's holding that, in situations where a fiduciary has to make a risky entrepreneurial decision, a breach of fiduciary duty only constitutes a criminal offense if the breach is serious. The Criminal Supreme Court held that the defendants did not face a risky entrepreneurial decision, as the appreciation awards only resulted in disadvantages for Mannesmann AG and, therefore, the defendants had no entrepreneurial discretion.

Conclusions for Corporate Practice

The reach of the Criminal Supreme Court's decision is still being debated. One subject of recent debate are “change-of-control” clauses, and whether the Mannesmann decision has rendered these provisions illegal. Change-of-control clauses are stipulations in contracts with executive board members that give each executive board member the right to terminate his or her own contract and receive a severance payment, usually amounting to between one and three

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years of compensation on top of the ordinary severance payment when a defined event, such as a takeover, occurs. These clauses are intended to relieve executive board members from personal financial pressures so that they can take a more neutral position on takeover offers by a third company.

The better view is that *Mannesmann* has not rendered these change-of-control clauses illegal, although the analysis would have to be done on a case-by-case basis. The *Mannesmann* Court expressly stated that it is permissible to provide a variable compensation component that is tied to the success of the corporation, if the total compensation remains reasonable. As change-of-control clauses are intended to promote a management’s neutral position regarding takeover offers, a company should be able to demonstrate that the payments associated with change-of-control provisions were both reasonable and tied to the company’s success. Nevertheless, according to news reports, former executive board members of HypoVereinsbank have allegedly been waiting for several months for severance payments pursuant to change-of-control clauses, because HypoVereinsbank appears uncertain about the legality of the payment.

It is also unclear whether a company’s supervisory board has the right to amend a contract with an executive merely to reward an executive for his or her extraordinary performance so that his or her compensation increases. Although, the Criminal Supreme Court stated that an executive’s success alone does not justify amending his or her contract to the disadvantage of the company, the court also stated that deferred extraordinary compensation is permissible if the resulting decrease of the corporation’s assets is in proportion to other gains incurred by the extraordinary payment. Therefore, if a corporation intends to retain an executive, and to provide an incentive for the executive or for others, an increase of the executive compensation still appears to be permissible. The analysis, however, will have to be done on a case-by-case basis.

**Popular Criticism of the Supreme Court’s Decision**

The Criminal Supreme Court’s decision has received mixed feedback among the general public and has been predominantly criticized by legal scholars. The most prevalent point of criticism is in regards to the court’s holding that payments to executives constitute a punishable breach of fiduciary duty if the corporation cannot benefit from such a payment in the future. Critics argue that this ignores the fact that executives should be awarded based on past performance. The critics argument seems particularly true because § 87 para. 1 of the Act on Stock Corporations stipulates that the supervisory board has to ensure that the total compensation of each executive board member is reasonable with regard to his or her tasks and the financial situation of the corporation. The Criminal Supreme Court disregarded this corporate law guideline for defining the scope of the supervisory board member’s fiduciary duty.

The *Mannesmann* Case, however, has not come to an end. In the new *Mannesmann* trial the defendants will probably try to attack the District Court’s prior finding that Mannesmann did not benefit from the payments of the appreciation awards. It is foreseeable that the an appeal will follow. The German media, supervisory board members, and the legal profession will continue to closely follow *Mannesmann* for years to come.
First Circuit


In In re Carnero v. Boston Scientific Corp., the First Circuit affirmed a lower court ruling that employees of foreign subsidiaries of publicly traded U.S. companies cannot sue the U.S. parent company for retaliation under the whistleblower provision contained in Title VIII, Section 806, of the Sarbanes Oxley Act of 2002.

The case involved a resident of Brazil who worked for a foreign subsidiary of Boston Scientific Corporation (“BSC”), who claimed he was terminated in response for telling BSC that Latin American subsidiaries had created false invoices and inflated sales figures. The First Circuit observed that “[i]nsofar as we know, no court has yet determined if this provision protects foreign citizens working outside of the United States for foreign subsidiaries of covered companies.” The court first “assumed without deciding” that the whistleblower protection applied to employees of a subsidiary—domestic or foreign—of a publicly traded company, not just to direct employees of the parent. The court reasoned that even though plaintiff actually worked for a BSC subsidiary—rather than BSC directly—the plaintiff was regularly supervised by the parent company’s personnel and because it was quite possible that the subsidiaries were agents of the parents, the subsidiaries’ employees would fit the definition of the parent’s employees.

The court then determined that the whistleblower provision lacked extraterritorial effect, such that a foreign employee who complained of misconduct abroad by overseas subsidiaries may not bring suit under the whistleblower provision of Sarbanes Oxley against a U.S. parent company. The court first recognized the “well-established presumption” against the extraterritorial application of Congressional statutes, and that this presumption could only be overcome if there is a “clearly expressed,” “affirmative intention” by Congress. Regarding the Sarbanes Oxley Act, the court noted that there were many indications from the text of the statute and its legislative history that Congress thought the statute was limited to the territorial jurisdiction of the United States. In contrast to the civil whistleblower protection at issue in this case, Congress had provided expressly elsewhere in the statute for extraterritorial enforcement of a different, criminal, whistleblower statute. With respect to the civil counterpart, however, Congress placed the provision’s enforcement in the hands of the DOL, a domestic agency, without any provision for possible problems arising when that agency seeks to regulate employment relationships in foreign nations. The court also noted that a number of practical problems existed in attempting to apply the whistleblower provision extraterritorially—including forcing courts to adjudicate relationships which would be better resolved by a country’s own courts and government agencies pursuant to its own laws.

In re Credit Suisse First Boston Corp., 431 F.3d 36 (1st Cir. Dec. 12, 2005)

In In re Credit Suisse First Boston Corp., the First Circuit held that an analyst’s report on a particular stock was a “statement of opinion” and therefore a plaintiff must plead specific facts showing that the analyst

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subjectively knew the report was false to bring a Section 10(b) claim.

Plaintiffs filed suit against Credit Suisse First Boston LLC (“CSFB”) alleging that that CSFB analysts issued “Buy” ratings for Agilent Technologies, Inc. (“Agilent”) stock despite “their lack of faith in the rosy picture they were painting.” According to plaintiffs, CSFB issued these bullish reports to curry favor with Agilent and secure future investment banking business. The complaint asserted that CSFB bankers would promise potential clients favorable analyst reports in exchange for business, and analysts who did not issue strong ratings for banking clients often suffered adverse consequences—including reduced bonuses or less desirable assignments. Plaintiffs allegedly purchased their stock at an inflated value based on CSFB’s ratings, and later suffered losses when the stock price plummeted.

On appeal, the court noted that although the reports were premised on some degree of objective fact, they ultimately conveyed an opinion about a stock’s prospects, and perhaps, about the stock market itself at a given time. The court also distinguished a stock rating from the typical false statement at issue in a Section 10(b) case because the former involves an outsider’s views about a corporation rather than a corporate insider’s factual assertions regarding his or her own company. Accordingly, the court concluded that most ratings are best understood as statements of opinion, not unadulterated statements of objective fact. The court noted that a plaintiff can challenge a statement of opinion by pleading facts sufficient to indicate that the speaker did not actually hold the opinion expressed (known as “subjective falsity”). Thus, in cases premised on misstatements of opinion, the falsity element entails (at a minimum) an inquiry into whether the speaker believed the statement to be false; in these situations, the court reasoned that the falsity aspect and the intent requirement “essentially merge.” The plaintiff must, for each allegedly false opinion, plead facts strongly suggesting that he or she did not believe that particular opinion to be true when uttered.

Since plaintiffs failed to plead such facts, the First Circuit affirmed the district court’s decision dismissing the complaint.

**Second Circuit**


A director who did not make a false or misleading statement and did not have knowledge of such a statement cannot be held liable as either a primary violator or an aider and abettor, under Sections 10(b) and 13 of the Exchange Act, and the rules promulgated thereunder, according to the Southern District of New York in SEC v. Cedric Kushner Promotions, Inc.

The SEC asserted that Steven Angel, a director of Cedric Kushner Promotions, and two other directors had violated the securities laws in two different filings that allegedly contained numerous misrepresentations and omissions, (including incorrect statements of cash flows, operating expenditures, and the number of shares outstanding), and fraudulently signed audit reports that had not been approved by the company’s auditors. Angel, however, played a “very background role” in the preparation of the forms, did not actually sign the forms, and only provided documentation to the inside and outside accounting staff.

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The court held that under the Second Circuit’s “bright line” test for primary liability, Angel could not be primarily liable because he was not involved in the alleged misrepresentations. On the aiding and abetting claim, the court held that the SEC must show knowledge of the violation by Angel, and proof that the Angel substantially assisted in the primary violation. The court expressly rejected the SEC’s argument that recklessness is a sufficient mental state for a director to be liable for aiding and abetting. The court further held that Angel’s conduct was not “a substantial causal factor in the alleged primary violation,” thereby precluding aiding and abetting liability.

**Seventh Circuit**


More than 10 years after the passage of the Private Securities Litigation Reform Act, the Seventh Circuit was presented with its “first opportunity … to address the heightened pleading requirements of the [PSLRA]” in *Makor Issues & Rights, Ltd., v. Tellabs, Inc.* In so doing, it issued a host of rulings that picked and chose among long-standing holdings in many circuits, but declined to follow any particular circuit wholesale.

Fundamentally, the Seventh Circuit recognized, as other courts have, that the PSLRA did not alter the substantive standard for scienter, which in the Seventh Circuit was “an extreme departure from the standards of ordinary care, [] which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.”

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The court made several important decisions that will affect how district courts within the circuit evaluate class action complaints. In evaluating whether a complaint pleaded the necessary “strong inference of scienter,” the Seventh Circuit rejected the “motive and opportunity test” employed by other circuits, including the Second and Third. Instead, the court held that it will “examine all of the allegations in the complaint and then [ ] decide whether collectively they establish such an inference. Motive and opportunity may be useful indicators, but nowhere in the statute does it say they are necessary or sufficient.”

While favoring defendants by rejecting reliance on motive and opportunity as a standalone basis for pleading scienter, the court tilted in favor of plaintiffs rejecting the rule employed in the Sixth Circuit and other courts that permitted courts to consider only the “most plausible” inference from a set of facts in a complaint. The court permitted a lower standard that “will allow the complaint to survive if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the requisite intent.”

In evaluating the use of confidential sources to overcome the “strong inference” standard, the Seventh Circuit followed the Second Circuit in holding that plaintiffs need not name or otherwise identify confidential sources in the complaint as long as the descriptions of the sources indicate they...
would have access to, or knowledge of, the facts underlying the allegations.

With regard to forward-looking statements, the court amplified its 2004 ruling in *Asher v. Baxter Intern., Inc.*, that a disclaimer for forward-looking statements provides a safe harbor only if it mentions “those sources of variance that (at the time of the projection) were the principal or important risks.” To be a meaningful cautionary statement entitled to protection, a disclaimer must identify particularized risks.

Finally, the Seventh Circuit followed the Fifth Circuit in rejecting the “group pleading” doctrine, which allowed evidence of one defendant’s knowledge or intent to be imputed to other defendants if they allegedly acted as a group. The court held that “plaintiffs must create this [strong inference of scienter] with respect to each individual defendant in multiple defendant cases.”

**Ninth Circuit**


In *Langley Partners, L.P. v. Tripath Technology, Inc.*, the Northern District of California rejected Section 10(b) fraud claims against the company, its officers and directors, but let stand a separate claim under Section 11 for a material omission in the company’s registration statement.

Plaintiff sued Tripath Technologies, a maker of digital chips, and its CEO and former CFO for violations of Sections 10(b) and 20 of the Exchange Act, Sections 11 and 15 of the Securities Act, and for fraud, breach of contract, and unjust enrichment. Plaintiff entered into a stock purchase agreement with Tripath in which plaintiff purchased one million shares of Tripath for $2.00 a share. Subsequently, the share price of Tripath declined when Tripath announced that it might have to restate revenues for one of its quarters and that its auditor had resigned. Plaintiff alleged that Tripath included false and misleading statements in its prospectus and public filings regarding its 2004 revenues and the likely success of one of its products, and omitted material information regarding its lack of internal controls.

Defendants contended that plaintiff had failed to satisfy the pleading requirements of the PSLRA. Plaintiff contended that it had adequately pleaded scienter by alleging violations of GAAP, insider trading by certain individual defendants, and misrepresentations regarding one of Tripath’s products. The Court disagreed, holding that while the allegations regarding Tripath’s statements regarding its revenues raised “an eyebrow of concern” and may have created an “inference” of deliberate recklessness, they did not create a “strong” inference of scienter. In addition, plaintiff’s allegations of insider trading had not alleged—as required—that such trading was “unusual.” Nor did the Court find that defendants had actually made any misrepresentations regarding Tripath’s products. Accordingly, the Court granted defendants’ motion to dismiss plaintiff’s Section 10(b) claim.

The Court did, however, deny defendants’ motion to dismiss the Section 11 claim. The Court found that plaintiff had properly pled specific facts stating that Tripath’s registration statements omitted material information regarding Tripath’s accounting methods and the stage of development of its product, and that this was sufficient for plaintiff to maintain its Section 11 claim.
Delaware


In _In re J.P. Morgan Chase & Co., S'holder Litig.,_ the Delaware Supreme Court held that compensatory or nominal damages were not available to stockholders of an acquiring corporation in a stock-for-stock merger where omitted disclosures result in overpayment by the acquiror.

JP Morgan Chase & Co. ("JPMC") acquired Bank One Corp. ("Bank One") in July 2004, in a stock-for-stock merger transaction. The transaction was overwhelmingly approved by JPMC stockholders. Shortly after the transaction was approved, The New York Times reported that Bank One’s CEO, James Dimon, had initially offered to do the transaction for "no premium" if he were immediately appointed CEO of the combined entity. The merger transaction ultimately had included a 14% premium for Bank One and had resulted in JPMC’s CEO, William Harrison, continuing as CEO of the combined entity for two years after which Dimon would succeed him.

JPMC shareholders brought a purported class action alleging JPMC directors breached their fiduciary duties by (1) approving a merger in which JPMC paid an unnecessary premium and (2) failing to disclose that the transaction could have been accomplished for no premium if Dimon had been selected as CEO of the combined entity.

The Court of Chancery dismissed the overpayment claims, as they were not direct claims, but rather derivative claims for which pre-suit demand had neither been made nor excused. It also dismissed the disclosure claims, which sought only money damages, under Rule 12(b)(6) for failure to state a cognizable claim for money damages. Plaintiffs appealed only the dismissal of the disclosure claim on the basis that under _In re Tri-Star Pictures, Inc.,_ 634 A.2d 319 (Del. 1993), disclosure violations automatically entitled plaintiffs to damages recovery.

The Supreme Court affirmed the Court of Chancery’s ruling that plaintiffs were not entitled to compensatory damages because any monetary compensation for overpayment in the merger would properly go to JPMC, not directly to its stockholders. Thus, compensatory damages were not available for the plaintiffs’ direct disclosure claim. The Supreme Court approved the Court of Chancery’s reasoning that holding otherwise would result in stockholders’ having the ability to recover twice the same damages—once on behalf of the corporation through a derivative action and again directly on behalf of the stockholders. This untenable outcome was flatly rejected.

The Court also affirmed the Court of Chancery’s determination that language in _Tri-Star_, suggesting a _per se_ rule of at least nominal damages for breaches of the duty of disclosure, had been limited by _Loudon v. Archer-Daniels-Midland Co.,_ 700 A.2d 135 (Del. 1997). Thus, properly stated, disclosure violations entitle shareholders to at least nominal damages only when stockholders’ economic interests or voting rights were impaired. As discussed, the stockholders’ economic interests had not been directly impaired. Dilution alone would support a claim for nominal damages only where “a significant stockholder’s interest is increased at the sole expense of the minority.” When, as in this merger, the benefit from the allegedly diluting transaction derives to

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a third party rather than to an existing or controlling stockholder, the holding in Tri-Star is inapplicable.


In *In re General Motors (Hughes) S’holder Litig.*, the Delaware Supreme Court held that courts can properly consider the entirety of a proxy statement in analyzing disclosure claims and also may consider the fact that a transaction was approved by shareholders in applying a ratification defense at the pleading stage.

In 2003, GM divested itself of its wholly-owned subsidiary, Hughes, through a sale to News Corporation. GM issued tracking stock for Hughes, and the holders of that stock received Hughes common stock and News Corp. American Depositary Shares in the transaction. Plaintiffs challenged the transaction by alleging various breaches of fiduciary duty against the GM directors in connection with the structuring and execution of the transaction. The Court of Chancery granted the defendants’ Rule 12(b)(6) motions to dismiss, holding that the vote of the stockholders was fully-informed and served to ratify any breaches of fiduciary duty by either extinguishing the claims or reinstating the presumptions of the business judgment rule.

A panel of the Delaware Supreme Court unanimously affirmed the Court of Chancery’s dismissal of the complaint with prejudice. The Court reaffirmed that in an action challenging the sufficiency or accuracy of a disclosure statement, the Court may consider the “entire contents” of the document without converting the motion to one for summary judgment. The Court further stated that it is proper to judicially notice the fact that a transaction has closed and that approval of a majority of stockholders was a necessary precondition to closing. Finally, the Court affirmed the Court of Chancery’s decision to take judicial notice of those facts, and the conclusion that the complaint did not state a claim for inadequate or inaccurate disclosures, in determining that any breaches of fiduciary duty were ratified by the fully-informed vote of a majority of the stockholders, resulting in dismissal of the complaint.

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SEC

SEC v. Thomas J. Bucknum,
CA No. 06-10065 (D. Mass.
Jan. 12, 2006)

On January 12, 2006, the Securities and Exchange Commission filed a settled enforcement action against Thomas Bucknum, the former general counsel of Biogen Idec, Inc. ("Biogen"), a Massachusetts biotechnology company. The SEC alleged Bucknum sold shares of the company’s stock after learning that two participants in a clinical trial for a new Biogen product were diagnosed with a serious brain disorder.

The Commission alleged Bucknum exercised his option to purchase 89,700 shares of Biogen stock with the intention of then selling them. Bucknum instructed his stockbroker to sell the shares for a price of $68 per share or higher. Biogen policy required Bucknum to seek approval before executing the transactions, which Bucknum’s broker sought and obtained. However, at noon that same day, Bucknum attended a meeting during which he learned of the negative clinical trial results for Tysabri, a potential multiple sclerosis drug. After this meeting, Bucknum again contacted his broker—this time directing that the shares be sold at the current market price, about $67 per share. The broker executed the trade that afternoon.

A week and a half after Bucknum’s stock sale, Biogen announced it was suspending the marketing of Tysabri due to negative clinical trial results. Biogen shares lost more than 42% of their value immediately following the announcement. Selling his shares prior to the Biogen announcement enabled Bucknum to reap “a substantial profit.” On the basis of these allegations, the Commission’s complaint charged Bucknum with violations of the anti-fraud provisions of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

To settle the charges, Bucknum agreed to: (1) a permanent injunction enjoining him from committing future violations; (2) pay $1,938,465 in disgorgement; (3) pay $102,005 in pre-judgment interest; (4) pay a civil penalty of $969,232; and (5) a prohibition from acting as an officer or director of any publicly-traded company for a period of 5 years. All told, Bucknum must pay $3,009,720. Bucknum neither admitted nor denied the allegations in the SEC’s complaint.
Enforcement Trends and Topics for 2006
Michael J. O’Leary

On December 13, 2005, the ABA hosted a teleconference entitled “SEC Hot Topics,” featuring Alan Beller, the Director of the SEC’s Division of Corporate Finance, Linda C. Thomsen, Director of the Division of Enforcement and moderator Dixie L. Johnson, Chair of the Committee on Federal Regulation of Securities of the ABA’s Section of Business Law. The SEC panelists stated for the record that they were espousing their own views on the topics for discussion and that those views do not necessarily reflect those of the Commission generally. Among other topics, the panelists highlighted the SEC’s major enforcement priorities for 2006 and beyond, as well as some of the guidance to be drawn from a few of the SEC’s enforcement actions in 2005.

Priorities and Areas of Focus in 2006

- **Focus on executive compensation and related party disclosure issues:** The panelists cited as an example the SEC’s enforcement action against Walt Disney for failing to disclose certain relationships between members of the some of directors’ families and the company and substantial “perks” provided to one of its directors. There is a general feeling that existing MD&A disclosures on this issue are often inadequate and companies should certainly be seeking to be more “robust” in this regard.

- **Continuing emphasis on “gatekeeper” actions against lawyers, auditors, and outside directors:** The panelists stressed, however, that the Enforcement Division is not concerned with innocent mistakes but rather instances in which the system “breaks down” or instances of gross negligence. They cited as examples the SEC’s action against an in-house attorney for Google who erroneously concluded that the company was exempt from certain registration requirements of employee stock options without ever apprising the company’s board of a potential issue, and its action against an outside director of the Chancellor Corp. in which there was evidence that the director signed inaccurate financial statements without even looking at them or possessing even a basic understanding of their contents.

Guidance Drawn from 2005 Enforcement Actions


In Siebel II, the district court dismissed the SEC’s complaint for a violation of Regulation FD. Regulation FD imposes liability on issuers for selective disclosure of material nonpublic information. The SEC premised its complaint on four material selective nonpublic disclosures made by Siebel's CFO at a private meeting with investors that allegedly conflicted or amended earlier public statements by the company. Notably, Siebel had settled an earlier Regulation FD action by the SEC in 2002 and there was perhaps some concern on the part of the SEC staff that Siebel was becoming a serial Regulation FD violator.

District Judge George Daniels ultimately dismissed the SEC’s claim, finding that the statements at issue were not nonpublic after considering them in the context of Siebel’s complete public statements regarding the issues rather than considering just the limited excerpts relied on by the SEC in its complaint. He also rejected the SEC’s approach of scrutinizing “every particular word used” in Siebel’s public statements at “an extremely heightened level.”

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substance of the decision arguably provides companies with a powerful contextual argument against future Regulation FD actions.

Though the SEC chose not to appeal the decision, the panelists respectfully disagreed with Judge Daniel's application of the law and viewed the holding as "extremely fact specific." While the court's decision in Siebel may appear to create a "safe harbor" for companies during private question and answer sessions, the panel stressed that companies should have controls in place to monitor compliance with Regulation FD requirements even during such informal sessions. While the panel agreed that prosecution of vague comments may have a chilling effect, they also believe that under certain circumstances even "winks and nods" to stock analysts in a private meeting can constitute an improper communication and they believe the SEC will continue to monitor the substance of such selective disclosures carefully.

- **Flowserve Corp: Suggestions on How to Avoid a Regulation FD Action**

Flowserve's CEO and Investor Relations director were charged with "reaffirming" earlier public earnings projections in a private conference call approximately a month after the company's most recent public earnings projections. After initially failing to respond to the violation, Flowserve and its CEO ultimately settled the charges with the SEC and accepted civil penalties of $350,000 and $50,000 respectively. The panel noted that the company's initial unwillingness to cooperate, specifically its unwillingness to acknowledge that a reaffirmation had occurred despite an 8-K conceding that fact, contributed to the final sanctions. The panel also observed that companies can take a number of common sense steps to avoid an FD action, including developing a clear Regulation FD compliance policy and taking steps to adhere to that policy. Investor relations personnel must be aware of the policy, must monitor the company's compliance, and in instances in which a violation is identified must take immediate steps to remedy it.

- **Titan Corporation: Lessons From the Section 21(a) Investigative Report Arising From a Settled Enforcement Action for Violations of FCPA From 1999-2001**

In a 2003 merger agreement with Lockheed Martin, Titan represented that neither the company, nor any of its subsidiaries, had engaged in violations of the Foreign Corrupt Practices Act ("FCPA"). Titan attached a copy of the merger agreement with these representations to a proxy statement that was publicly filed and distributed to its shareholders. The Titan Section 21(a) report highlights that an issuer may be held liable for such false statements contained in an exhibit to a public filing. The panel stressed that the report was not intended to imply that the attached contract somehow becomes an indirect covenant with "stealth" third party beneficiaries but rather that even statements made in a non-disclosure document that are attached to public filing may be deemed as disclosures. One possible solution to this problem is to include general disclaimers in the filing itself as to all statements made in attached contracts or similar transactional documents. However, a general disclaimer may not be enough where the party is actually aware of a false statement in those attachments. The ultimate lesson to be drawn from the Titan 21(a) report is that companies must carefully consider the potential liabilities of attaching such documents to their disclosure filings.

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Securities Litigation and Professional Liability Practice, First Quarter 2006

Showdown Over SLUSA: An Update (Continued from Page 1)

"purchase or sale" has been interpreted broadly in other contexts, and that Congress’ intent in enacting SLUSA was to impose a uniform, rigorous standard on all private securities class actions. In support of its reasoning, the Second Circuit pointed to the Supreme Court’s 1975 *Blue Chip Stamps v. Manor Drug Stores* decision, which limited private 10b-5 actions to buyers and sellers. As the Second Circuit reasoned, if “holders” were not entitled to bring actions under Rule 10b-5 because they were not injured “in connection with a purchase or sale,” holders also should be excluded from SLUSA, which used the same “in connection with” language. Congress “borrowing language with a settled judicial interpretation in the context of private damages actions, and such borrowing implicates the strong presumption that Congress is aware of and approves that construction”.

Merrill Lynch successfully petitioned the Supreme Court for a writ of certiorari.

The Seventh Circuit’s *Putnam Funds II* Decision Challenges the Second Circuit

While Merrill Lynch’s petition was pending, the Seventh Circuit’s Judge Easterbrook issued his *Putnam Funds II* decision, which directly challenged the Second Circuit’s reasoning in *Dabit*. Specifically, Judge Easterbrook argued that the Second Circuit had both misinterpreted *Blue Chip Stamps* and ignored a trio of subsequent Supreme Court decisions indicating that *Blue Chip Stamps* did not truncate the overall scope of Section 10(b) and Rule 10b-5.

Under Judge Easterbrook’s interpretation, *Blue Chip Stamps* simply represents a judicial constraint on a judicially-created right of action (the right of private parties, as opposed to government entities, to bring Rule 10b-5 claims). Judge Easterbrook pointed to language in *Blue Chip Stamps* indicating that the Supreme Court desired to confine such private actions to situations where litigation was apt to do more good than harm, noting the Justices’ observation that “anyone can say that a failure to trade bore some relation to what the issuer did (or didn’t) disclose, but that judges and juries would have an exceedingly hard time knowing whether a given counterfactual claim (‘I would have traded, if only . . .’) was honest.” Thus, in Judge Easterbrook’s formulation, *Blue Chip Stamps* represented the Supreme Court’s decision to limit private securities actions to harms arising out of actual trading (which narrows the effected class and simplifies proof), while leaving other securities offenses—including “holders” claims—to public prosecutors.

The Supreme Court Favors the Seventh Circuit—and Uniformity

The Supreme Court’s *Dabit* decision represents a complete vindication of Judge Easterbrook’s reasoning. Justice Stevens clarified that *Blue Chip Stamps* was not an attempt to define the phrase “in connection with the purchase or sale,” but rather a more limited holding that private litigants in federal securities actions lack standing to bring suit under Rule 10b-5 unless they can show that they engaged in a transaction as a result of the alleged misrepresentation. The *Dabit* decision endorses a liberal reading of the actual “in connection with” language, noting the Court generally has “espoused a broad interpretation” of the phrase.

“The requisite showing, in other words, is deception in connection with the purchase or sale of any security, not deception of an identifiable purchaser or seller.”

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Justice Stevens also noted that Congress’ intent in enacting SLUSA was to eliminate precisely the sort of “wasteful, duplicative litigation” that would result from allowing “holders” claims to proceed in state court.\(^{17}\)

Justice Stevens underscores the importance of SLUSA with a telling fact also noted by Judge Easterbrook: prior to the PSLRA, there was “essentially no securities class action litigation in state court.”\(^{18}\) After the PSLRA was enacted, with its stringent pleading requirements for federal securities actions, there was a temporary decline in federal securities class actions accompanied by a corresponding increase in state court filings.\(^{19}\) Moreover, the vast majority of these new cases were being filed in conjunction with nearly-identical federal court actions—often by the same plaintiffs’ firms. SLUSA was enacted in response to this transparent “end-run” around the PSLRA, a goal that would be frustrated by allowing state-law “holder” suits to go forward.\(^{20}\)

In sum, the *Dabit* Court’s unanimous holding significantly benefits issuers and securities litigation defendants. As an initial matter, SLUSA’s promise of national uniformity in securities class actions is advanced by the foreclosure of private “holder” claims, which had been recognized by some states, but not by others. Moreover, the *Dabit* decision limits plaintiffs’ ability to use state court claims—which are not subject to the PSLRA’s discovery stay—in conjunction with federal securities actions to increase the costs of defense and force settlement of even meritless suits. The *Dabit* decision also prevents plaintiffs from using state-law “holder” suits as a convenient means of avoiding the much-despised board demand requirements of shareholder derivative suits. Finally, and most importantly, the *Dabit* decision diminishes the risk of having to defend two (or more) actions arising from the same set of facts, but subject to radically different substantive and procedural requirements that could lead to inconsistent substantive rulings.

### The Supreme Court’s Next Step: Resolving the Remaining SLUSA-Related Circuit Split

On April 24, 2006, the Supreme Court will hear an appeal of Judge Easterbrook’s *Putnam Funds* decision,\(^{21}\) which opened the first, more limited SLUSA-related split between the Second and Seventh Circuits.

Prior to the June 2004 *Putnam Funds* decision, the Second and Ninth Circuits issued a trio of cases holding that a district court’s decision to remand an action that had been removed to federal court under SLUSA was not appealable.\(^{22}\) These decisions relied on a trio of Supreme Court cases interpreting 28 U.S.C. § 1447(d), which states that “[a]n order remanding a case to the State court from which it was removed is not reviewable on appeal.” While the language in Section 1447(d) is sweeping, the Supreme Court has limited its scope to those cases remanded due either to (1) lack of subject-matter jurisdiction; or (2) irregularities with the procedure of removal. Drawing on the Supreme Court’s holdings, the Second and Ninth Circuits determined that cases removed under SLUSA and subsequently remanded due to lack of subject-matter jurisdiction fall squarely within the ambit of Section 1447(d) and its prohibition of appellate review.

In his *Putnam Funds* opinion, Judge Easterbrook argued that the Second and Ninth Circuits erred in not looking beyond the “jurisdictional label” used by the district courts in their remand orders. Although these remand decisions were cast as having been based on a “lack of subject-matter jurisdiction,” Judge Easterbrook argued that this label was incorrect. More precisely, the *Putnam Funds* decision holds that when a district court reviews and then remands a case removed to federal court under the auspices of SLUSA, the remand is—despite the language used by the district court—based not on a lack of subject-matter jurisdiction, but rather is a decision on the merits:

> We must distinguish between a decision that ‘this court lacks adjudicatory competence’ and a decision that ‘the court has been authorized to do X and having done so should bow out.’ The former implies lack of subject-matter jurisdiction, as [prior Supreme Court decisions] explain; the latter implies the presence of jurisdiction.\(^{24}\)

Thus, Judge Easterbrook argued, the Second and Ninth Circuits failed “to recognize the difference between a case that never should have been removed and a case properly removed and remanded only when the federal job is done.”\(^{25}\)

Whether the Supreme Court agrees with Judge Easterbrook that the Second and Ninth Circuits

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Lessons to Learn from SEC v. KPMG: The Contours of Auditors’ Liability for Securities Fraud and Under Section 10A
(Continued from Page 3)

N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994), which held that Section 10(b) could not support private aiding and abetting claims because such claims could be proven without any showing of the critical element of reliance. Focusing on the import of the reliance element, the court therefore looked to the Second Circuit’s most recent discussion of the issue in In re Scholastic Corp. Securities Litigation, 252 F.3d 63, 76 (2d Cir. 2001), which held that a company officer’s intimate involvement in drafting, and primary responsibility for, his company’s misrepresentations were sufficient to establish primary liability, even if the misrepresentations were not publicly attributed to the defendant. The Scholastic case suggests, in other words, that a plaintiff may establish primary liability against a company officer based upon a showing that the plaintiff relied only upon the company’s statement.

While the Court’s survey of law is useful for assessing the standards for primary liability facing private claimants, the SEC need not prove the element of reliance when it brings enforcement claims of securities fraud. The Court, therefore, stopped short of holding that Scholastic would support primary liability against the KPMG individual auditors in a private action. Instead, deriving logical support from Scholastic nonetheless, the Court held that in an SEC enforcement action, public attribution to a defendant is not required to establish primary liability, “so long as the SEC is able to show that the defendant was sufficiently responsible for the statement—in effect, caused the statement to be made—and knew or had reason to know that the statement would be disseminated to investors.”

Applying this standard, the Court found the three engagement partners “responsible” for the statements at issue. The Court based its finding, however, solely on citations to the KPMG Audit Service Manual existing at the time, which stated that the engagement partner is “responsible” for the quality of the audit, “directing the audit” and “forming the audit opinion.” It is curious that the Court did not cite to GAAS, including the AICPA professional requirements which dictate the responsibilities of audit firms and auditors, in reaching its conclusion.

Indeed, in considering whether the concurring partner could be deemed “responsible” for KPMG’s statements, the Court rejected his argument that only the AICPA standards are relevant. The Court also looked to the Audit Service Manual, finding that the relevant inquiry was that partner’s “actual authority under the circumstances, not merely the scope of his duties under GAAS.” (Emphasis added.) The Court, in fact, noted provisions of the Audit Service Manual which gave a concurring partner the authority “to prevent an audit opinion from being issued” unless issues raised by the concurring partner were resolved. But the Court ultimately overcame the suggestion of “responsibility” that could be inferred from this provision, finding that a concurring partner instead provided more of a limited, negative assurance-type function and was not responsible for the audit opinion. He thus could not be held primarily liable, the Court found, and granted summary judgment to the concurring partner on this claim.

Recklessness is Generally Insufficient to Establish Aiding and Abetting Liability

In holding that there were triable issues of fact regarding whether the engagement partners acted with scienter, the Court applied the well-recognized standard that recklessness, rather than actual knowledge, was sufficient to establish this element for primary liability under Section 10(b). The SEC argued that recklessness was also sufficient to establish the liability of the concurring partner for aiding and abetting, but the Court held that actual knowledge of fraud was required.

The SEC cited to certain pre-Central Bank case law regarding the standard for aiding and abetting violations. In effect, the SEC’s argument was that Section 20(e), which was passed in response to Central Bank to ensure that the SEC could seek aiding and abetting liability even if private plaintiffs could not, codified the law prior to the Supreme Court’s decision. But the Court surveyed the pre-Central Bank case law and determined that it was by no means uniform. In fact, the Second Circuit’s pre-Central Bank case law supported the view that recklessness may have been insufficient.

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sufficient to establish scienter in an aiding and abetting claim only when the defendant owed a fiduciary or disclosure duty to the plaintiff, without which the assistance “must be knowing and substantial.” SEC v. Lybrand, 200 F. Supp. 2d 384, 400 (S.D.N.Y. 2002) (summarizing Second Circuit law based on pre-Section 20(e) precedent). Even if the Court were to apply this authority, it found the concurring partner had no such duty. However, the Court held that the statute does not permit a finding of scienter based on anything less than actual knowledge of the misstatement because: (1) Congress passed Section 20(e) at the same time it passed 15 U.S.C. § 78u-4(f)(10)(A), which defines “knowingly” to require “actual knowledge” of the misrepresentation, and it can be inferred that Congress meant the same definition to apply to Section 20(e); (2) Congress considered and rejected a proposed amendment to the statute that would have added “recklessness” to the standard and (3) Congress was aware that the pre-Central Bank law was not uniform.

Although the Court held that the SEC produced sufficient evidence to warrant trial on whether the concurring partner had actual knowledge of fraud—based on disputed facts regarding audit workpapers seen by or attributed to the concurring partner—the Court’s apparent first-impression holding setting the standard for aiding and abetting claims brought by the SEC is noteworthy.

**Liability Under Exchange Act Section 10A**

Section 10A, enacted with the Private Securities Litigation Reform Act in 1995, required “the independent public accountant” performing an audit to take certain steps when it detects evidence that an “illegal act . . . has or may have occurred.” SOX, however, changed “the independent public accountant” to “the registered public accounting firm,” a term defined to include the legal entity itself and any “associated person” designated by the rules of the PCAOB. The court noted that the PCAOB has issued no rules on point, but that SOX elsewhere defined an “associated person” as any person who acts as an agent of or receives compensation from the firm, with an exception that the PCAOB may exempt ministerial employees from the definition (which the PCAOB had not, in any event, done). This elaborate legislative analysis, leading the Court to the conclusion that the individual KPMG partners would be covered by the amended Section 10A, ultimately appears to have been *dicta*—since the Court held that the amendment in SOX may not be applied retroactively against the individuals. See Landgraf v. USI Film Prods., 511 U.S. 244, 280 (1994). So the Court conducted an equally-elaborate statutory interpretation analysis for the pre-SOX “independent public accountant” term used in Section 10A, which was undefined in the PSLRA.

The Court first looked to the language of various pieces of the PSLRA to determine if Section 10A liability may and should be imposed on both accounting firms and their individual auditors involved in an audit. Specifically, one subsection of Section 10A specifically gave (and still gives) the SEC the power to bring administrative proceedings against “the independent public accountant and any other person that the Commission finds was a cause of such violation,” pursuant to which the SEC developed a practice of initiating such proceedings against individual accountants. The Court, however, found this inapplicable because Congress could have, but did not, use the same conjunctive description in the subsection at issue in this case. The Court also looked to the language of SOX in trying to understand Congress’ intent behind the words used in the PSLRA. First, the SEC pointed out, SOX broadly defines the term “public accounting firm” to include associated persons, but the court found this irrelevant to interpret a different term in a different statute. Second, the SEC pointed to SOX’s explicit provision that nothing in that Act may be construed to impair the SEC’s authority to pursue any action “against any registered accounting firm or any associated person thereof.” The Court found, however, that this statement could just as easily support the interpretation that SOX expanded the SEC’s authority, and that the PSLRA version did not allow...
Section 10A claims to be brought against persons associated with the accounting firm conducting an audit.

Looking to the PSLRA's legislative history, the Court found it littered with numerous ambiguous references to “accountants” and “auditors” without corresponding references to accounting firms. Furthermore, the Court found contextual evidence supportive of the SEC’s position, such as an SEC regulation which pre-existed the PSLRA and referred to an “independent public accountant” as a natural person, and the fact that the Section 10A requirements under the PSLRA were based upon existing GAAS, which “generally prescribe rules of conduct for the individual auditor and her assistants.” (Emphasis in original.)

But ultimately, none of these arguments could overcome the strong presumption that the plain text of the PSLRA version of Section 10A itself meant what it said. The statute used the term “the independent public accountant” rather than “an independent public accountant,” the Court noted, and thus reflects “Congress’s decision to impose Section 10A’s obligations on a single actor.” In this case, the accountant certifying Xerox’s financial statements was KPMG, not any of the individual auditors. “When an accounting firm signs an audit or is engaged to perform the audit, Section 10A’s obligations most appropriately fall on the firm.” The Court thus granted summary judgment to the auditors who moved on this ground.

Conclusion

This decision clarified the law in several meaningful respects. First, on the facts of this case, the Court held that the concurring partner could not be held primarily liable for violations of Section 10(b) of the Exchange Act or Section 17(a) of the Securities Act. But the Court’s holding that primary liability may only attach to persons who “in effect, caused the statement to be made” will have wider application. Second, where primary liability will not apply, the Court’s holding clarifies that a claim for aiding and abetting liability must include proof of actual knowledge, as opposed to recklessness. Third, for pre-SOX conduct, Section 10A lies only with the accounting firm conducting an audit, not any individuals within the firm. Finally, the Court’s willingness to reach past GAAS and into an accounting firm’s audit manual in determining the applicable standards for liability under the securities laws should be a signal for accounting firms to continue to consider them in the context of litigation.

(Endnotes)

1 Peter W. Devereaux is a partner in Latham & Watkins’ Los Angeles office and practice group co-chair of the Global Securities Litigation and Professional Liability Practice. Robert J. Malinek is an associate in the New York office and a member of the Securities Litigation and Professional Liability Practice.

2 Claims for aiding and abetting violations of Sections 13(a) and 13(b) of the Exchange Act were also brought by the SEC against the individuals, but no argument was provided by any party in support of summary judgment on these claims. In addition, one of the engagement partners moved for summary judgment on the SEC’s apparent pursuit of claims premised on “price increases and extensions to existing leases,” which the court granted because the SEC’s complaint failed to put him on notice of such claims.

3 Additionally, in order to establish knowing and substantial assistance, some courts have held, based upon pre-Central Bank precedent, that “a defendant’s inaction or silence may qualify where the defendant recklessly violates an independent duty to act or manifests a conscious intention to further the principal violation.” See, e.g., SEC v. Tambone, --- F. Supp. 2d ---, 2006 WL 488570, at *8 (D. Mass. Jan. 27, 2006). See also footnote 4, infra.


5 Another decision in the Southern District of New York has already expressed agreement. In SEC v. Cedric Kushner Promotion, Inc., --- F. Supp. 2d ---, 2006 WL 397903, *9 (S.D.N.Y. Feb. 17, 2006), the court held that actual knowledge of the fraud must be proven in aiding and abetting claims, even as to a director defendant owing a fiduciary duty to the company and shareholders on whose behalf the SEC seeks relief.
“were mesmerized by the word ‘jurisdiction’” remains to be seen. What is clear, however, is that once again the high Court will be faced with an opportunity to further Congress’ express goal of promoting uniformity in private securities litigation. Rejection of the Putnam Funds I decision would limit the ability of securities defendants to seek redress for even a clearly erroneous district court decision to remand an action properly preempted by SLUSA. Adopting Judge Easterbrook’s reasoning, by contrast, would allow conflicting district court decisions on SLUSA to be reviewed and reconciled by the circuit courts of appeals.

Conclusion: The Road Ahead

The Supreme Court has issued two pro-issuer securities litigation rulings in less than a year. The first, Dura, ensures a robust application of the Reform Act’s loss causation requirement, while the second, Dabit, closes a potential loophole in SLUSA’s coverage. The Putnam Funds appeal presents the possibility that the Court will strike a third blow in favor of national uniformity in securities class actions. Should the stars align in this way, the time may be ripe to seek the “holy grail” of the private securities defense bar: a uniform federal scienter pleading standard.

(Endnotes)

1. Christian Word is a partner and Greg Harris is a senior litigation associate in Latham & Watkins’ Northern Virginia office. They specialize in securities class action litigation and professional liability defense.


5. SLUSA states that: No covered class action based upon the statutory or common law of any State or Federal Court by any private party alleging—

(1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or

(2) that the defendant used or employed any manipulative or deceptive devise or contrivance in connection with the purchase or sale of a covered security.

(Emphasis added.)


12. Id. at 40.


14. Putnam Funds II, supra note 6, at 483.

15. Dabit, supra note 2, at 12.

16. Id. at 13 (internal citation omitted).

17. Id. at 14.

18. Id. at 15. The Reform Act’s reach was limited to federal claims—a crucial oversight that Congress later explained by noting that “state-court class actions involving nationally traded securities were virtually unknown” at the time the statute was enacted. S. REP. NO. 105-182, at 4 (1998).


20. Congress found that securities plaintiffs sought “to evade the protections that Federal law provides against abusive litigation by filing suit in State, rather than Federal, court,” which “prevented [the PSLRA] from fully achieving its objectives”). Id. at 14.


22. See United Investors Life Ins. Co. v. Waddell & Reed, Inc., 360 F.3d 960 (9th Cir. 2004); Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 332 F.3d 116 (2d Cir. 2003); Abada v. Charles Schwab & Co., 300 F.3d 1112 (9th Cir. 2002).


24. Putnam Funds I, supra note 22, at 850.

25. Id. at 851.
The best solution is to hold individuals accountable because someone in the company cooked the books. We ought to hold individuals accountable, not shareholders.10

Other critics argued that the SEC’s mechanism for assigning damages “has often been capricious in its determination of the amount of penalties.”11 The U. S. Court of Appeals for the District of Columbia Circuit, for example, recently held—while striking down SEC-imposed penalties against an investment advisor, albeit not a public company—that the SEC acted “arbitrarily and capriciously” when it levied hundreds of thousands of dollars in penalties without stating the reasons for doing so.12

In response to the argument that corporate penalties hurt shareholders, proponents asserted that the Fair Funds provision in the Sarbanes-Oxley Act ensures that shareholders will not be further victimized by the imposition of a penalty, presumably because the penalty can be distributed to shareholders rather than sent to the United States Treasury. Proponents also argued that corporate penalties help to amplify the Commission’s message and help to deter illicit behavior by other public companies. It is for this reason that virtually every SEC Litigation Release or Press Release announcing an enforcement action where a large corporate penalty has been imposed trumpeted some variation of the phrase this action will send a message. According to former Director Cutler, “[a] single enforcement action has the potential to effect change on an enormous scale, causing the development or enhancement of internal controls, supervisory procedures, and compliance functions at hundreds of other companies.” The imposition of corporate penalties, says former SEC Commissioner and General Counsel Harvey Goldschmid, also creates “powerful incentives for [a public company to institute] preventative programs and procedures.”13 Similarly, current SEC Commissioner Roel Campos has said that “[e]xecutives do not want to be responsible for corporate penalties on their watch.”14

The SEC’s Statement on Corporate Penalties

The SEC’s recent Corporate Penalties Statement attempts to explain the current Commission’s philosophy in light of these competing views. According to the Statement, which is reportedly the result of 40 hours of Commission meetings,15 whether or not to impose a penalty on a corporation—as opposed to an individual—in a particular case “turns principally on two considerations.” The Commission first weighs “[t]he presence or absence of a direct benefit to the corporation as a result of the violation,” which includes assessing whether shareholders have received an improper benefit. The Commission then weighs “[t]he degree to which the penalty will recompense or further harm the injured shareholders,” which includes assessing whether innocent shareholders will bear the burden of the penalty and whether the penalty can be used to recompense injured shareholders.16

Seven additional factors are identified by the Statement as proper to consider in determining whether to impose a penalty on a corporation. These factors are:

• The need to deter the particular type of offense;

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• The extent of the injury to innocent parties;
• Whether complicity in the violation is widespread throughout the corporation;
• The level of intent on the part of the perpetrators;
• The degree of difficulty in detecting the particular type of offense;
• The presence or lack of remedial steps by the corporation; and
• The extent of cooperation with the SEC and other law enforcement agencies.

“The result” of the Corporate Penalties Statement, says Chairman Cox, “should be to give greater transparency to the workings of the SEC.”

In connection with the release of the Statement, the SEC also provided examples of these principles in action. It contrasted two settled enforcement actions—SEC v. McAfee Inc. and In re Applix Inc.—to illustrate why, under its new policy, one corporation might receive a penalty and another might not. In the case against McAfee, the SEC charged that the corporation’s securities law violations—alleged improper revenue recognition, channel stuffing, and fraudulent recordkeeping—merited the imposition of a $50 million civil penalty. According to the current Director of the Division of Enforcement, Linda Chatman Thomsen, McAfee’s illicit conduct was not only “pervasive” but, in the Commission’s view, but also benefited the company: “[d]uring the time period of the fraud McAfee used its overvalued stock to acquire other companies, capitalizing on the artificial value it had created through its fraud.” Thomsen also pointed out that McAfee is “financially strong,” and thus a penalty would be unlikely to cause “undue hardship” to its shareholders and could be “effectively distributed” to injured investors.

In contrast to McAfee, in Applix the Commission did not find that the corporation’s securities law violations—alleged improper recognition of approximately $1.2 million in revenue—merited the imposition of a civil penalty and instead imposed a cease and desist order. According to Thomsen, neither Applix nor its shareholders benefited from the company’s illicit conduct. In addition, Applix—unlike McAfee—is a “relatively small company and a large financial penalty could have a disproportionate effect on its financial situation with hardship flowing to its shareholders.” Thomsen described the alleged fraudulent conduct in Applix as “more limited,” because the alleged fraud was limited to three responsible individuals. The Commission is pursuing charges against those individuals separately.

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In the most significant settled enforcement action since the release of the Corporate Penalties Statement—where a $100 million penalty was levied against American International Group (AIG)—the Commission appeared to apply the criteria articulated in the Statement. As to direct corporate or shareholder benefit, the publicly-disclosed facts regarding the AIG settlement say very little, suggesting only that AIG distributed its stock in a stock-for-stock corporate acquisition during the period of the fraud. (Whether this was the only putative improper benefit from the company’s alleged violative conduct is unclear.) As to effect on current shareholders, the Commission stated that its settlement will “deliver meaningful monetary relief to those harmed by AIG’s prior conduct.” Other allegations highlight several secondary factors that, if true, would tend to weigh in favor of imposing a penalty against AIG, including that there was widespread complicity in the violation, that fraudulent intent animated the actions of the individual violators, and that there was a strong interest in deterring others similarly situated from misusing insurance and reinsurance transactions. In addition, the penalty amount reflects use of the Statement’s mitigating factors, as it takes into account AIG’s substantial cooperation during the Commission’s investigation and the company’s remediation efforts.

What will happen to penalties after the statement?

The Corporate Penalties Statement is helpful because it provides a basic framework for analysis. Moreover, the discussion in the Statement suggests a step back from the regime where “large penalties seem to be part of virtually all significant settlements.” But the real significance of the Statement will not be known until the Commission has applied it over time in a series of enforcement actions. Even now, several important issues remain unresolved:

1. A Penalty Should Reflect Cooperation, but Who Judges Cooperation and What Credit is Given?

Cooperation, as defined by the Commission, has been a part of the corporate penalty calculus since the Statement on the Relationship of Cooperation to Agency Enforcement Decisions in 2001 (“Cooperation Statement,” also called the “Seaboard Report”). Cooperation can be in the eye of the beholder, however, and here the beholder is SEC staff. Even after a corporation makes what it views as a good-faith effort to respond appropriately to possible corporate misconduct, SEC staff, with the clarity of 20/20 hindsight, may conclude that the response was inadequate and worthy of harsh sanction. Some SEC staffers seem not to appreciate the difficulties posed by uncertainties about underlying facts and by competition for scarce corporate resources. Unfortunately, in the settlement of an SEC investigation, there is rarely judicial oversight and thus no independent arbiter of disagreements about the extent of a corporation’s cooperation.

What constitutes cooperation under the Commission’s statements has only been described in the abstract and is not easily distilled from Commission enforcement actions, which generally do not specify what level of cooperation a corporation provided.
The Corporate Penalties Statement emphasizes again the importance of cooperation, and makes clear, if there was any doubt, the Commission’s view on a corporation’s obligation to self-report misconduct. This new statement, without additional analysis or support, states that “it is incumbent upon management to report” securities law violations when they are discovered. This rhetoric seems to suggest that a corporation cannot self-correct possible violations without self-reporting or other public disclosure.

Since the Cooperation Statement in 2001, the Commission has, on multiple occasions, noted the effect of cooperation on the ultimate size of a penalty. Lucent’s settlement with the SEC in 2004 for alleged improper revenue recognition exemplifies the Commission’s treatment of companies it deems uncooperative. That settlement included a $25 million penalty for Lucent’s “lack of cooperation.” By contrast, “the Commission did not seek a penalty from [Royal] Ahold” in 2004 for alleged securities law violations it described as “yet another deplorable example of a massive, multifaceted fraud at a major corporation.” No penalties were imposed in part because of “the company’s extensive cooperation with the Commission’s investigation.”

Despite the existence of some examples like Lucent and Royal Ahold, what constitutes cooperation under the Commission’s statements has only been described in the abstract and is not easily distilled from Commission enforcement actions, which generally do not specify what level of cooperation a corporation provided. Thus, while it is clear that the Commission places a high value on cooperation, defining that value with precision is difficult.

2. The SEC’s System for Calculating Corporate Penalties Remains a Black Box. Public companies under investigation by the SEC, and their shareholders, are justifiably concerned about the size of recent payments required to settle enforcement actions. During the SEC’s past fiscal year, corporate penalties included two penalties of greater than $250 million. Penalties against financial institutions directly regulated by the SEC (including those that are public companies), where the SEC has traditionally exacted tougher penalties, include at least eleven more penalties above $25 million. During the SEC’s past fiscal year, penalties have included three penalties between $125 and $300 million, and at least ten more penalties above $25 million. The Statement is silent on how the Commission will determine the dollar amount of a penalty, but in a press briefing on January 4th, Chairman Cox clarified “that all of the factors enumerated in the statement are also applicable in determining the magnitude of a penalty, once it is decided that a penalty will be imposed.”

However, the approach taken by the Commission is still very different from that used when a corporation pleads guilty to a crime. The United States Sentencing Commission, for example, has prescribed much more specific parameters for assessing fines on corporations in its Guidelines Manual. The Sentencing Guidelines provide for a range of fines that are dependent on the offending corporation’s offense level and culpability. The National Association of Securities Dealers has prescribed similar parameters on penalties in its Sanction Guidelines.

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3. How Long Will It Take for Shareholders to Benefit from Fair Funds?

The Corporate Penalties Statement makes clear that shareholder interests should be considered carefully before a penalty is imposed. According to the Statement, because the Fair Funds provision allows corporate penalties to be used to compensate defrauded shareholders, it provides an additional rationale for imposing a penalty against a corporation. But more than three years after Sarbanes-Oxley, have penalty monies actually benefited victimized shareholders? A recent report by the Government Accounting Office suggests that the answer is no. The August 2005 GAO report surveyed the SEC’s distribution of penalty funds to victimized shareholders under Fair Funds, and noted that, by mid-2005, the SEC had “designated almost $4.8 billion to be returned to harmed investors.” However, at the time of the GAO report just "$60 million from only three cases have been distributed to harmed investors, and funds totaling about $25 million from only one other case were being readied for distribution."

Conclusion

The Commission should be commended for shedding light on the exercise of its authority to levy corporate penalties. However, several practical issues are lurking in the shadows for public companies facing the possibility of an SEC enforcement action. The resolution of those issues awaits future enforcement actions in which the Commission applies the criteria articulated in the Corporate Penalties Statement.

(Endnotes)

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4 104 Stat. at 938.


6 See, e.g., Lyle Roberts, *End the Dual Approach*, The National Law Journal (Oct. 24, 2005) ("The ‘Fair Funds’ program, as it is known, has provided an incentive for the SEC to seek significant penalties from corporations.").


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15 See McTague, SEC Unveils.


17 Speech by SEC Staff: Statement regarding McAfee, Inc. and Applix, Inc. (Jan. 4, 2006) ("Thomsen, Penalties").


19 thomsen, Penalties.


22 AIG Press Release.

23 AIG Complaint, ¶ 75 ("AIG’s then-CEO and as its senior executives working on the transactions understood, the transactions did not constitute genuine reinsurance.").

24 See, e.g., Linda Chatman Thomsen, Speech by SEC Staff: Remarks Regarding SEC v. Ronald Ferguson, et al. (Feb. 2, 2006) (stating that one AIG and four General Re executives "knowingly helped AIG achieve a specific, and false, accounting effect").

25 Id. ("More broadly, the case is part of the SEC’s industry-wide investigation of the misuse of insurance and reinsurance products to commit accounting fraud. The message of these cases is simple-cooking the books is a recipe for disaster.").

26 Cutler, Penalties.


32 See McTague, SEC Unveils.


34 Id., § 8C2.4-6.

35 NASD, SANCTION GUIDELINES (last updated Mar. 2004).

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