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Inside This Issue:

A Note from the Editors

In this issue of the Securities Litigation and Professional Liability Newsletter, we look back at the year 2006.

Any such review must address the stock option backdating allegations that exploded onto the scone in 2006. In addition to stock option issues, we examine how lower courts in the US have been applying and interpreting *Dura Pharmaceuticals, Inc. v. Broudo*, the US Supreme Court decision that required plaintiffs in a 10(b) action to plead and prove "loss causation." We also look at a decision that could signal yet another attack on the attorney-client privilege. Finally, as always, we review key cases decided by US Circuit and District courts.

Like Caesar's Wife – Above Suspicion: Practical Advice for the Internal Investigation of Option Grants

By Paul H. Dawes and Kory Sorrell

In this environment of intense administrative scrutiny and florid media attention, it is imperative that public companies take proactive measures to detect stock option mismanagement, report any potential issues, and cooperate with investigations to minimize the impact of any wrongdoing. In this article, we discuss the nature of an internal investigation of stock option grant practices and offer detailed practical advice based on recent experience.

The Internal Investigation

Management of any public company having reason to believe it may have an options backdating issue should strongly consider taking steps on its own initiative. The internal investigation is an important tool in responding to issues raised in this context as it provides the company a way to maintain investor confidence, demonstrates an effective compliance program and potentially protects directors and officers from liability for failure to exercise oversight. The company and the board may effectively distance themselves honorably from the culprits, demonstrate good faith, conduct remedial measures and seek to maintain a positive public image. An internal investigation enables the company to prevent or mitigate regulatory investigations, exposure to government enforcement actions and private litigation. Finally, independent auditors who become aware of possible

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wrongdoing are obligated to assess the potential impact of these actions on the company's financial statements.[2] The auditors may include the status and results of a company's internal investigation in its financial statement risk assessment, rendering a portion of its own independent investigation of the company unnecessary.

The Role of the Special Committee

Given the times, and the less-than-stellar records and related minute-keeping practices of some compensation committees, all companies should review the status of their options documentation. If a company believes that it has potential options dating issues, then the company should consider forming a disinterested committee of outside board members, *i.e.* directors not involved in the granting of the stock options being investigated. Ideally, these members were on the board and were not affiliated with the company during the time-period in question. The first issue a special committee should address is whether the company needs to conduct an inquiry at all. Clearly, if the company is aware of information suggesting misconduct, financial misstatements or an existing regulatory inquiry, then the company should hasten to commence an inquiry as soon as possible. The next step in this process is to obtain independent legal counsel ("special counsel") experienced in conducting internal investigations. Independent counsel is a *sine qua non* of an independent investigation because companies that endeavor to undertake inquiries themselves or by using regular and long-standing counsel are too often suspected of trying to address sensitive facts and may not have the skills, knowledge or requisite appearance of objectivity.

It is crucial at this juncture that the company portray itself to the government, investment community and media as having integrity and genuine commitment to uncovering the facts underlying any potential dating issues (and, of course, act with such integrity and commitment). The company should therefore publicly disclose that it has discovered serious potential issues involving the granting of stock options, formed a special committee of independent directors to review the company's granting practices and obtained independent counsel to assist with the inquiry. Taking these steps promptly and pro-actively affords the company significantly greater control over conducting the inquiry through independent counsel and will better position it to formulate defenses against potential litigation and respond to subsequent regulatory and criminal inquiries.

The Special Committee should next work with special counsel to determine the appropriate scope of the inquiry and provide the board a written resolution setting out the nature and scope of the investigation. This resolution should confirm in writing the retention of special counsel, state the issues under review, and make it clear that counsel is to advise the committee of the company's legal rights and obligations, as well as any potential liabilities. All communication in this matter should be deemed confidential and protected by attorney-client privilege. Special counsel should also be given authority at this time to retain additional professionals, including forensic auditors and investigators.

The Role of Special Counsel

Special counsel in an internal investigation is uniquely situated among a number of interested parties. Special counsel reports directly to the special committee, to which authority has been delegated by the company's board of directors, during its investigation. But special counsel will be expected ultimately to report to the full board and possibly represent the company in its presentations to the independent auditors, NASDAQ, the Securities and Exchange Commission (SEC) and the US Department of Justice (DOJ). Using special counsel for these purposes, as well as for conducting the investigation, is advantageous to the company in several ways.

First, independent attorneys play an important role in the investigation by preserving the attorney-client privilege. In order to maximize the protections of the attorney-client privilege, the retention letter between the Company and special counsel should state the purpose of the investigation and that all employees and consultants involved should report to special counsel. Special counsel should either conduct or be present at all witness interviews to preserve the privilege, and any documentation of these interviews should be appropriately documented to reflect that special counsel was present and that the communications were made subject to the privilege. Additionally, the documentation of the interviews, such as interview memoranda, summaries, etc., should be drafted to ensure the writings are protected by the work product doctrine. To maximize this protection, the interview documentation should be drafted by special counsel and should state formally that interview memorandum is not a verbatim account, but reflects the "mental impressions, conclusions, and opinions" of counsel. Discoverable verbatim accounts, recordings or signed statements should also be avoided.

Second, outside counsel should provide a new and comparably unbiased view of facts already familiar to inside counsel and employees may be far more willing to disclose their knowledge or concerns about management to independent counsel. Third, and this cannot be overstated, outside counsel is likely to have far greater credibility with government entities and the investing community.

How to Conduct the Investigation

As soon as the investigation commences, special counsel must establish a document retention practice at the company. A memo should be sent to all relevant employees and the information technology department, instructing them to secure all hard drives and suspend all document destruction. Directors and employees also should preserve all potentially relevant documents, including paper documents, e-mails and files at employees' homes or on laptops. An employee uninvolved in the potential backdating issue should be designated to collect documents. Periodic reminders to preserve documents, on a weekly or monthly basis, are essential to document preservation. Technical experts should also be retained at this time to search for, and preserve, all sources of electronic documents, including deleted email, attachments and spreadsheets. Once the relevant documents are obtained, all documents should be reviewed and logged in the same way as one would during traditional litigation.

Preferably, witness interviews should commence after key documents have been reviewed, provided that time permits. Careful consideration must be given to who should attend each interview for the purposes of obtaining objective responses and witnesses should be given a preliminary overview of the interview subject matter. Examination skills are key. Special counsel must participate in all witness interviews and officers and employees must comply with requests for interviews, and should be told they have a duty to cooperate with the internal investigation as a condition of employment. The attorney must be careful not to mislead witnesses and should inform witnesses that the special counsel represents the company, not the individual witness, and that the attorney-client privilege may be waived by the company at its own discretion. Under the American Bar Association's Model Rule of Professional Conduct 1.13(f), the attorney must explain to the witness that the attorney's client is the corporate entity, when the attorney knows or "reasonably should know" that the interests of the company and the witness are adverse.[3] Special counsel cannot advise witnesses to get separate counsel.

From the outset, special counsel should proceed with an eye to developing a careful record of the investigation. The record should include an initial analysis of the factual record, conclusions, and a chronology of actions (including meeting minutes) taken by special counsel should be maintained. Witness interviews should be memorialized in a manner that is consistent with the attorney work product doctrine and the ultimate purpose of the investigation. Despite these protections of the attorney-client privilege and work product doctrine, special counsel should always assume that work product will be discoverable at a later date and should draft accordingly.

During the investigation, special counsel should actively report back to the special committee, receive feedback and guidance, and conduct further investigations as necessary before preparing a final report (if done). Careful consideration also must be given to whether to create a final report and, if so, the form of the final report. Special counsel must decide whether this report will be written narrative, a computerized presentation such as PowerPoint or oral. Whether the report will likely be reviewed by government authorities or plaintiffs' attorneys is a consideration. In the current environment of heightened scrutiny, cooperation with regulatory inquiries is gravely important and this may well lead to sharing the results of internal investigations with the SEC and DOJ. The company's practical necessity to interface with independent auditors may also require a graphic report. This very well may in turn constitute a waiver of work-product protection and the attorney-client privilege in subsequent civil litigation.

It is also important to remember, however, that informing the SEC does not necessarily translate into informing the public. Disclosures of internal investigations and subsequent decisions made must be calibrated carefully. However, if disclosure to the public is inevitable, or if the issues involve acts of serious misconduct, it is better to advise the market sooner rather than later. Waiting to disclose an internal investigation could give weight to the perception of market fraud, widespread corporate wrongdoing and obfuscation. These are the very impressions the special committee and internal investigation should seek to avoid.

Remedial Action

Depending on the results of the investigation, there are numerous potential implications for employees implicated in options backdating. The company should consider a leave of absence, recoupment of profits gained through backdating, re-pricing the backdated options, termination of options and termination of the employee "for cause" as possible responses to the results of its internal investigations. Litigation may be necessary. It is imperative that the company demonstrate its integrity and commitment to addressing any wrongdoing by taking a hard stance with regard to anyone implicated in the backdating of options. This is crucial not only to preserving the company's reputation in the market, but also in anticipation of possible external inquiries or civil suits. Collateral consequences may be involved.

The company should immediately develop a comprehensive plan for administering stock options in the future. The company must implement standard review practices of option grant awards in order to prevent future backdating. This should most likely be accomplished through the audit committee, and outside auditors should be incorporated into the review process. At a minimum, a regimen should be established for determining when options will be granted. The company's comprehensive plan should then be formally adopted by the board and provided to the investing community (on its website, for example).

Conclusion

Interest in option grant practices has ballooned in recent months, but investigation of individual companies is still at a very early stage. Under circumstances where potential backdating issues arise, it is crucial that public companies be proactive. Companies must secure independent counsel and take immediate measures to demonstrate to the government, investment community and media a genuine commitment to uncovering the facts of any issues potentially related to options backdating. By initiating its own internal investigation and hastening to take appropriate remedial action, the company may assume significant control over review of its own practices, better position itself against shareholder litigation, and mitigate or altogether avoid regulatory investigation.

Endnotes

[1] Staff Audit Practice Alert No. 1, Public Company Accounting Oversight Board, Matters Related to Timing and Accounting for Option Grants (July 28, 2006), *available at* http://www.pcaob.org/News_and_Events/News/2006/07-28_Release.pdf.

[2] Model Rules of Prof'l Conduct R. 1.13(f). ■

Introducing the Latham & Watkins LLP Compendium of Securities Law in 2006

Latham's Securities Litigation and Professional Liability practice group has compiled a Compendium of noteworthy legal decisions and important developments in the area of securities law and litigation during 2006.

The Compendium summarizes decisions from every federal circuit in the US and the Delaware state courts; contains sections on the most notable decisions, releases and guidance from the SEC and the PCAOB; and includes a section summarizing significant decisions and legislative actions in the UK. To obtain the password and link to the Web site, please contact Maiya Shaw at maiya.shaw@lw.com.

If you would like to discuss the Compendium, please contact any member of the group, or your attorney contact at the firm.

Will D&O Carriers Step Up to the Plate on Stock Options?

By Peter Rosen and Blair Connelly

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The stock option dating and timing issues raise a host of legal problems on subjects as diverse as tax, executive compensation, employee benefits, financial reporting, corporate governance and securities liability. Companies, directors and officers faced with these issues may incur substantial legal expenses from regulatory proceedings and private litigation. They might assume that their Directors' and Officers' (D&O) liability insurance policies will cover those expenses, as well as any judgments or settlements that may result from the litigation.

That assumption should not be made lightly. The wave of corporate earnings restatements (and the resulting litigation) several years ago prompted many D&O carriers to seek rescission of their policies or otherwise seek to nullify their coverage duties; and it is reasonable to assume that at least some carriers will make similar attempts in response to this growing scandal. Indeed, already some insurers have been submitting questionnaires regarding a company's option practices as part of the insurance renewal process. In effect, these carriers are requiring the insured to certify that it has no option dating or timing issues.

As discussed below, there are several major issues that D&O carriers may raise in response to claims arising from stock option dating and timing, either as grounds for denying coverage for these cases, or, at a minimum, reserving their right to do so in the future.

A Primer on D&O Liability Insurance

D&O policies are designed to protect directors and officers against personal liability for claims based on acts taken in the course of their duties. The goal is to make sure that talented people are not discouraged from assuming important responsibilities out of concern for personal liability. Although many companies indemnify their directors and officers for liability arising out of such claims, there are legal limits on the extent to which they can do so. D&O liability insurance is designed to fill that gap and provide a greater level of comfort to the directors and officers.

A typical D&O policy will contain two (and often three) distinct coverages.[1] The first, called "Side A" coverage, protects the directors and officers against claims for which the directors and officers *cannot* be indemnified by the company. The second, "Side B" coverage, is designed to reimburse the company for expenses it incurs in indemnifying its directors and officers against claims for which the company *can* indemnify the directors and officers. The third aspect, called "Side C" coverage, protects the company against securities claims.[2]

D&O policies are generally "claims-made" policies: that is, a "claim" is covered if it is first "made" against the insured person during the policy term.[3] The policy typically requires the insured to report the claim to the insurer promptly after learning of it, and in any case within the policy term or a designated period after the term ends.[4]

Given these basic principles, a director or officer would reasonably expect to be protected against any claims made against him or her arising out of the stock option dating and timing scandal. However, there are a host of subsidiary issues that lurk beneath the surface.

Does the Policy Cover Intentional Acts?

D&O policies typically state that they will provide coverage for any "Loss"[5] arising out of a "Claim" based on a "Wrongful Act" by the insured director or officer. While the definitions of these terms will vary from one policy to another, the term "Wrongful Act" is frequently defined to include any actual or alleged error, misstatement or action or failure to act in connection with the company's regular activities.

In recent years, however, some insurers have been changing their policy definition of "Wrongful Act" to include only *negligent* acts or omissions. If the policy is so limited, the carrier may attempt to deny coverage on the ground that the option dating was an intentional act, and therefore any claim against the director or officer based on it falls outside the policy's coverage.[6]

Even if the policy only provides coverage for negligent acts and omissions, coverage for a matter involving option dating or timing will depend to a large extent on the nature of the underlying claim. For example, if the plaintiff alleges that a director or officer deliberately backdated his or her options for personal gain, a court might find that the claim is not covered under a policy that extends only to negligent acts or omissions. However, if the plaintiff is suing the board of directors for violating their duty of care by failing to exercise proper oversight, the court may find that the claim sounds in negligence and is therefore covered.

Did the Incident on Which the Claim is Based Occur After the Retroactive Date?

As noted above, coverage under the D&O liability insurance policy depends in the first instance on whether the claim is "made" during the policy period, regardless of when the incident that gives rise to the claim occurred. However, the policy will also normally have a "Retroactive Date" that is individually negotiated with the carrier at the time the policy is sold. For coverage to apply, the incident on which the "Claim" is based must have occurred after the Retroactive Date.[7] If the incident occurred before the Retroactive Date, the claim may not be covered.

> **Even if the policy only provides coverage for negligent acts and omissions, coverage for a matter involving option dating or timing will depend to a large extent on the nature of the underlying claim.**

For example, in *ML Direct v. TIG Specialty Insurance Co.*, the policy had a "prior litigation" exclusion that barred any claim arising out of "any prior and/or pending litigation as of" the retroactive date, or "any fact, circumstance, or situation underlying or alleged in such litigation or matter."[8] The court found that this exclusion barred coverage for lawsuits that arose from the same facts as other lawsuits that were pending before the retroactive date, even though the insureds who sought coverage were not parties to those prior lawsuits.

The Retroactive Date may present significant problems in the context of option grants, particularly those made many years ago.[9] If the option was granted before the Retroactive Date, the insurer may argue that the option grant is the "incident" and therefore any claim arising from it is not covered. The insured, on the other hand, may argue that the "incident" is the date on which the option was actually exercised (or at a minimum, when it vested).

How a court will rule on this question is difficult to predict. The answer may depend to some extent on the nature of the underlying claim for which coverage is sought. For example, if the claim is based on the terms of the grant itself (*e.g.*, an accounting or tax claim), then a court might find the grant date to be the relevant time in deciding whether the incident took place before the Retroactive Date. On the other hand, if the claim is based on a receipt of excess profits, the court might view the exercise date as the relevant time.

Are There Any Applicable Coverage Exclusions?

Some insurers have recently adopted "options exclusions" to their policies, precluding coverage for claims arising out of the issuance or use of stock options. Insurers whose policies contain such exclusions will obviously rely on them in the context of claims arising out of option timing issues.

There are also several more common policy exclusions that the D&O carrier might point to as grounds for denying coverage. For example, many policies include a "Personal Profit" exclusion that bars coverage for any claim arising out of an insured person gaining any personal profit to which he or she "was not legally entitled."

In *TIG Specialty Insurance Co. v. Pinkmonkey.com*, the Fifth Circuit applied a "personal profit" exclusion to bar coverage for a state court judgment against directors and officers for misrepresentations in connection with the sale of certain stock to the plaintiffs.[10] The court held that because the jury in the underlying action found that one of the directors and officers had benefited from his false representation, the exclusion applied and the insurer had no duty to indemnify for the resulting judgment.

The precise wording of the exclusion can have broad implications. Some exclusions by their terms apply only where there has been a "final adjudication" that the insured person received an improper personal profit. Under this formulation, the insurer will normally defend the case subject to a reservation of rights, until there is a judicial determination of improper profit. However, other iterations of this exclusion apply where the insured person has "in fact" received such a profit. When the exclusion contains this language, insurers have sometimes sought declaratory judgments that the insured person "in fact" received an improper personal profit, thus entitling the insurer to deny coverage, even before there has been any adjudication of the underlying claim.[11] This places the insured director or officer in the uncomfortable position of defending against both the plaintiff in the underlying action and his own insurer – *both* of whom seek to prove that he did something improper.

The insurer might also use this language to try to avoid paying for the defense of the underlying claims. In *Federal Ins. Co. v. Kozlowski*, the D&O carrier for Tyco International Ltd. sought to avoid its duty to defend Tyco's former CEO, Dennis Kozlowski, in certain underlying litigation, on the theory that he had "in fact" obtained a personal profit from his wrongdoing. The trial and appellate courts rejected this argument because the underlying claims did not *solely* allege activity that led to a personal profit. Thus, even though the insurer may not ultimately have to pay for any damages assessed due to actions of Kozlowski that led to a personal profit, it still had to pay for the defense of those underlying claims.

Other common exclusions raise similar issues. The policy may contain exclusions for: claims based on dishonest, fraudulent or criminal acts, or claims based on remuneration paid to the director or officer without required approval.[12] In each case, an important point will be whether the exclusion requires a final adjudication of wrongdoing or whether it contains the more open-ended requirement of wrongdoing "in fact."

Some insurers may attempt to shoehorn claims based on option dating and timing into exclusions that were never intended or designed to apply to stock option issues. For example, some D&O policies have "commission exclusions" that are designed to exclude coverage for claims based on commissions, gratuities or favors to or for the benefit of the company's customers. The purpose of the exclusion is to preclude coverage for claims based on payment of kickbacks and the like; by no stretch of the imagination was it ever intended to preclude coverage for claims based on stock option controversies. However, the wording of some commissions exclusions – which are written in broad terms in order to capture a wide range of kickback activities – might be so broad that insurers could claim that they apply to payments made to or benefits received by the company's *own* officers or employees. Insurers may try to seize upon such an ambiguity, and claim that the exclusionary clause extends to claims based on option dating and timing. Insureds should scrutinize these and any other exclusions during the renewal process, to avoid such potential unintended consequences.

Is Misconduct Imputed to Otherwise Innocent Directors and Officers?

Depending on the wording of the exclusion, the insurer may be able to argue that a single officer's misconduct defeats coverage for all other directors and officers (as well as the company) arising out of the same incident.

In *TIG Specialty Insurance*, for example, the court found that the "personal profit" obtained by *one* of the directors and officers barred coverage for *all* of the others (as well as the company) because the exclusion applied to "any Claim made against *any Insured* arising out of … any Claim based upon, arising from, or in consequence of *an Insured* having gained in fact any personal profit, remuneration or advantage to which such Insured was not legally entitled."[13] The court found that this language did not require that the "Insured" for whom coverage is sought have received an improper personal profit, as long as some other Insured had done so as part of the same Claim.[14]

The *TIG Specialty Insurance* decision was premised on the wording of the exclusion; policies with different language may be distinguishable. The policy may also have a so-called "severability" provision stating that the insurance will be treated as a separate contract with each Insured, and that the liability of the Insurer to one Insured will be independent of its liability to any other Insured.[15]

Conclusion

These are only a few of the D&O liability insurance issues that may arise with respect to claims based on stock option dating or timing. Any such claims should be handled with great care, in consultation with your in house counsel, risk manager or outside insurance coverage counsel, to ensure that valuable insurance rights are preserved and honored.

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Endnotes

1 The precise coverage will, of course, depend on the terms of the specific policy; these statements are generalizations about what is typically found in D&O policies.

2 A main purpose of "Side C" coverage is to avoid a potential dispute between the carrier and the company. If there were no "Side C" coverage, and a securities claim were brought against both the company and its directors and officers, the carrier would only be responsible for liability attributable to the directors and officers, not the company itself. This would give the carrier an incentive to argue that the liability was attributable more to the company itself than to the directors and officers, and that therefore the company should pay a greater share of it. The presence of "Side C" coverage alleviates the problems arising from this kind of allocation dispute, because the carrier is responsible for the liability of *both* the company and its directors and officers. Some policies have allocation provisions that require the insureds and the insurer to negotiate in good faith about how to allocate responsibility for a judgment or settlement between the directors and officers on the one hand and the company on the other. Other policies will set a specific allocation percentage in advance.

3 By contrast, "occurrence" policies apply when the "occurrence" that is the basis for the claim (*e.g.*, the alleged wrongful act) took place during the policy period, regardless of when the claim is made.

4 However, some D&O liability insurance policies require that the claim be both made and reported within the policy period.

5 Although different policies will have different definitions, "Loss" is typically defined to include "damages, judgments, settlements and Defense Costs." In some cases, insurers have successfully argued that litigation recoveries that are restitutionary in nature are not "damages" and thus do not fall within the definition of covered "Loss." *See Level 3 Communications, Inc. v. Federal Ins. Co.*, 272 F.3d 908 (7th Cir. 2001) ("An insured incurs no loss within the meaning of the insurance contract by being compelled to return property that it had stolen, even if a more polite word than "stolen" is used to characterize the claim for the property's return.").

6 *See, e.g., Oak Park Calabasas Condominium Assn. v. State Farm Fire and Cas. Co.*, 137 Cal. App. 4th 557 (Cal. App. 2 Dist. 2006) (holding that language of D&O liability insurance coverage grant applied only to negligent acts and omissions).

7 Although the Retroactive Date is individually negotiated, the date on which the company first bought D&O insurance is often used as the Retroactive Date.

8 79 Cal. App. 4th 137, 144 (Cal. App. 2 Dist. 2000).

9 Last year, a Wall Street Journal article noted a significant level of option grants that occurred during the stock price decline that occurred in the weeks following the September 11, 2001 terrorist attacks (which allowed executives to receive options with exercise prices far below their previous trading prices). *Executive Pay: The 9/11 Factor*, Wall Street Journal Online, July 15, 2006.

10 375 F.3d 365 (5th Cir. 2004).

11 *See Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376 (D. Del. 2002) (rejecting insurer's effort to avoid coverage for securities class action based on personal profit exclusion); *Nicholls v. Zurich American Insurance Group*, 244 F.Supp.2d 1144 (D.Colo. 2003) (granting summary judgment for insurer; no duty to defend underlying case where all of the alleged conduct fell within "personal profit" exclusion).

12 *See, e.g., Serio v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 18 A.D.2d 319, 795 N.Y.S.2d 529 (App. Div. 1st Dept. 2005) (coverage for judgment against former president of defunct entity for improper use of corporate funds barred by "dishonesty exclusion" in D&O liability insurance policy).

13 375 F.3d at 371 (emphasis in original).

14 *Id.* at 371-72.

15 *See Wedtech Corp. v. Federal Ins. Co.*, 740 F. Supp. 214 (S.D.N.Y. 1990) (denying rescission of policy with respect to individuals who did not participate in fraud, based on severability language in policy). ■

Is *Dura* Durable? Are the Lower Courts Reducing Loss Causation to Its Lowest Common Denominator?

By Laurie B. Smilan

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In 2005, the Supreme Court handed securities class action defendants a well-earned victory when it affirmed the rule under Section 10(b) and Rule 10b-5 that plaintiffs must plead and prove "loss causation – *i.e.*, a causal connection between the material misrepresentation and the [plaintiffs'] loss." *Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627, 1631 (2005). Siding with the majority of Circuits, the Supreme Court affirmed that where plaintiffs "fail to claim that [the] share price fell significantly after the truth [concerning facts that were alleged to have been previously misrepresented] became known," loss causation cannot be shown.[1]

Dura rejected the notion that the mere allegation that the stock price was inflated by a misrepresentation at the time of plaintiffs' purchase coupled with the assertion that the stock price subsequently declined could ever be sufficient to establish loss causation. Instead, the *facts* must *support* the alleged causal connection. This is not possible where, as in *Dura*, the matters allegedly misrepresented and the matters subsequently disclosed that precipitated a loss are not closely related. The Supreme Court made clear that absent a relationship between the challenged misrepresentation and the later disclosure, plaintiffs could not establish that any loss was *caused* by the challenged misrepresentation as opposed to the other unrelated disclosures proximate to the actual decline. As the Court explained:

> When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price.[2]

Prior to *Dura*, other courts had recognized that, if under the alleged facts, "plaintiffs would have lost their investment regardless of the fraud, any award of damages to them would be a windfall."[3] These courts held that plaintiff's, claim fails when "it has not adequately plead facts which, if proven, would show that its loss was caused by the alleged misstatements as opposed to intervening events."[4] "[T]he complaint must allege facts that support an inference that [the defendants'] misstatements and omissions concealed the circumstances that bear upon the loss suffered such that *plaintiffs would have been spared all or an ascertainable portion of that loss absent the fraud*."[5] *Dura* seemed to endorse this approach, in emphasizing that the purpose of the securities laws was "not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause."[6]

Defense practitioners hailed *Dura*, one of the first securities cases to be heard by the Court in more than a decade, and the first to interpret these key provisions of the Private Securities Litigation Reform Act, as a potential silver bullet. The plaintiffs' loss causation allegation rejected in *Dura* – averring a purchase at an inflated price – was a formulaic standard found in many securities laws complaints. However, perhaps to the defense bar's surprise, plaintiffs have now shown just how easily the

Dura bullet can be dodged. In *Dura* itself, the same trial judge on remand *upheld* the complaint's loss-causation allegations with just a few tweaks, despite the Supreme Court's ruling. Plaintiffs solved their loss-causation problem merely by pointing to the post-class period stock price drop that occurred when the bad news was disclosed. Because that "causal connection" was now alleged, the amended complaint was upheld, even though the disclosure that allegedly caused the loss occurred long after the end of the class period when plaintiffs had originally claimed that the "truth" was first revealed.

Why was this so? Because the *Dura* trial court determined that "[t]he Supreme Court's decision did not create a heightened pleading standard for loss causation" and "did not affect Rule 8(a)(2)'s applicability."[7] The Court thus held that "[u]nder the liberal pleading requirements of Rule 8(a), these allegations are sufficient to meet the loss causation requirement."[8]

In reaching this conclusion, the *Dura* trial court noted:

> When presented with this case, the Supreme Court could have held that as a matter of law Plaintiffs cannot establish loss causation because the corrective disclosures regarding [the asthma device] were made several months after the Class Period ended. The Supreme Court did not so hold and instead only required the Plaintiffs to properly allege a causal connection between the economic losses suffered and the Defendants' representations.[9]

This interpretation – that the Supreme Court objected to the "inflation at the time of purchase" approach originally employed in *Dura* and thus required only that the plaintiffs point to a stock price decline that related to the subject matter of the challenged misrepresentation – takes much of the wind out of the defense bar's sails.

Since the Supreme Court's decision, courts have taken the view that "[t]he Supreme Court's decision did not create a heightened pleading standard for loss causation," instead "not[ing] its holding did not affect Rule 8(a)(2)'s applicability."[10]

All hope need not be lost for *Dura's* potential to crack down on frivolous claims. Whatever the pleading standard, whether assumed merely *arguendo* or adopted, the Supreme Court's decision in *Dura* makes clear that pleading bare conclusions of law (*i.e.*, alleging that "[i]n reliance on the integrity of the market, [the plaintiffs] . . . paid artificially inflated prices for Dura securities and the plaintiffs suffered 'damage[s]' thereby") is insufficient.[11] Whether the standard is Rule 8(a)(2) or Rule 9(b), it is well-established that the court need accept as true only "well-pleaded" allegations of fact, and not conclusory statements of law or unsupported statements of fact. As *Dura* also teaches, conclusory allegations are particularly ripe for rejection where the facts – *i.e.*, a stock price decline well prior to any revelation of adverse facts – are inconsistent with the cause-and-effect conclusion plaintiffs wish to draw.

Rule 8 does not require the court to check logic and reason at the door. Whatever the pleading standard, "generalized, vague or overbroad allegations regarding the existence of a disclosure or revelation of fraud that is merely alleged to have been connected to a drop in stock price will not suffice."[12]

No matter what the standard, loss causation requires, as the name implies, a "causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff."[13] The issue is not whether the challenged statements were the reason plaintiffs invested or whether they were false, or even whether the plaintiffs subsequently lost money. Rather, the issue is whether the very misrepresentations plaintiffs challenge can be shown to have *caused* plaintiffs' loss when the "truth" about the matters allegedly misrepresented or concealed is finally disclosed or materializes.

As stated by the court in *Lentell v. Merrill Lynch*:

> [T]o establish loss causation, "a plaintiff must allege … that the *subject* of the fraudulent statement or omission was the cause of the actual loss suffered," *i.e.*, that the misstatement or omission *concealed* something from the market that, *when disclosed, negatively affected the value of the security*.[14]

Where this "causal link" is not established by well-pled allegations, no claim of securities fraud may lie. In certain circumstances, defendants may still rely on logic and *Dura* to attack loss-causation pleadings, no matter the pleading standard.

Plaintiffs Cannot Establish Loss Causation Where the Stock Price Decline Results From the Announcement of Matters Different Than Those Alleged to Have Been Misstated

Dura established that Plaintiffs cannot demonstrate loss causation by pointing to losses at the end of the class period where those announcements that precipitate the stock price decline have no relationship to the matters alleged to have been misstated. In *Dura*, the class period ending stock drops did not result from disclosure of the "truth" that the challenged class period statements were in error. Instead, the plaintiffs attempted to link an alleged misstatement regarding a particular fact (the prospects for a new product in development that never went to market) to a stock drop following disclosure of an unrelated fact (general news of poor earnings results from other existing products). Because the stock drop was not triggered by disclosure of the "truth" regarding the new product, the trial court and then the Supreme Court held that there was no nexus between the misrepresentation and loss that could not satisfy plaintiffs' burden to plead loss causation.[15]

Plaintiffs May Establish Loss Causation Only Where the Truth Concerning the Challenged Misrepresentations Remains Concealed Until It Ultimately Materializes or is Disclosed

As a corollary to this first principle, where plaintiffs allege that the challenged misstatements were *never* disclosed to be false, the requisite causal connection between the loss and the challenged misconduct also cannot ordinarily be shown.[16] A plaintiff's loss causation allegations are self-defeating where the disclosures alleged in the Complaint "did not reveal the truth about the alleged scheme to keep the price of [the Company's] stock artificially inflated, but rather perpetuated it."[17] In such circumstances, the "proximate cause of th[e] plunge" during the class period "[could] not be the fact that investors learned the [still undisclosed] truth about the scheme that led to [the loss]."[18]

Second, *Merrill Lynch* and other cases in the Second Circuit have posited that loss causation may be shown in the absence of a curative disclosure where "plaintiffs . . . allege facts to establish that the [defendants'] misstatements and omissions concealed the . . . risk . . . *that materialized* and played some part in diminishing the market value of [the stock]."[19] In other words, if the risks are not disclosed by defendants but then materialize (and thus become known) loss causation may be shown on the basis of the resulting stock price decline. *In re Parmalat Sec. Litig.* is a good example of a case where loss causation was properly alleged on the basis of materialization of a previously undisclosed risk.[20] In *Parmalat*, "the risks *concealed* . . . [were] that Parmalat had massive *undisclosed* debt and was unable to service it" and that "[t]he *concealed* risk materialized when Parmalat suffered a liquidity crisis" and was unable to pay its obligations.[21] Parmalat's resulting bankruptcy – the materialization of the undisclosed risks about its liquidity – provided the causal link between the alleged omissions and plaintiffs' losses.

In contrast to *Parmalat*, a plaintiff **cannot** show a causal link between the allegedly undisclosed risk of a liquidity crisis and a subsequent bankruptcy where "contemporaneous public statements repeatedly revealed the Company's liquidity situation."[22] In *Glover v. DeLuca*, the plaintiff argued that the Company's disclosures about the liquidity risk were only "indirect and "partial," but the Court, reviewing a long list of disclosures about the Company's liquidity situation between the date of the plaintiff's purchase and the "materialization" of the risk, found that the "disclosures herein were neither indirect nor partial."[23]

The "common thread" between "materialization" and "disclosure" of the risk cases is that loss causation can be demonstrated only where the risk – the specific risk that is ultimately disclosed or materializes – was **previously undisclosed**.[24] As the *Catton* court explained, the Second Circuit has

> [r]eferred to several possible standards for pleading loss causation, including "direct causation," "materialization of the risk," and "corrective disclosure" . . . *[T]he "common thread is that, in each situation, the loss be foreseeable and [] the loss be caused by the materialization of the concealed risk."* [Thus], where the alleged misstatement conceals a condition or event which then occurs and causes the plaintiffs' loss, a plaintiff may plead that it is the materialization of the undisclosed condition or event that causes the loss. Alternatively, a plaintiff may identify particular disclosing events that reveal the false information, and tie dissipation of the artificial price inflation to those events (emphasis added).[25]

The *Catton* court held that loss causation could not be shown in that case because there was "no particularized allegation . . . supporting the theory that the disclosure or the materialization of [any] concealed risk led to plaintiffs' loss."[26]

This limitation – that loss causation can be shown only where the "true facts" or risks were previously undisclosed – is correct as a matter of logic in order to demonstrate a direct causal nexus. It is also necessary because, otherwise, plaintiffs would (and often do) use the "materialization of the risk" rubric to plead loss causation in every case where risks materialize – where the issuer has a liquidity crisis, becomes subject to a restatement, an investigation, or litigation, or files for bankruptcy – in other words, in most every case plaintiffs file. Thus, as *Merrill Lynch* instructs, where "substantial indicia of the risk that materialized are unambiguously apparent on the face of the disclosures alleged to conceal the very same risk," loss causation cannot be shown.[27] Cases where risk disclosures are made, *i.e., Glover*,[28] are "sharply distinguishable from [cases like *Parmalat*] in which some or all of the risk that materialized was clearly concealed by a defendant's misstatements and omissions."[29]

Similarly, to plead loss causation, plaintiffs may not merely "note that a stock price dropped after a bankruptcy announcement, [without] *alleging that the market's acknowledgment of prior misrepresentations caused that drop*" (emphasis added).[30] Where a plaintiff fails to allege that the "bankruptcy announcement disclosed any prior misrepresentations to the market," "[the] observation that a stock price dropped on a particular day, whether as a result of a bankruptcy or not, is not the same as an allegation that a defendant's fraud caused the loss."[31]

Where the announcement of a restatement, investigation, litigation, or bankruptcy does not also disclose or clearly result from some previously undisclosed risk, loss causation cannot be established.[32] Instead, in such circumstances it "seems reasonable to infer that the market responded to the news of the possible bankruptcy . . . [since] nothing [in the release] would tip off investors to the 'truth' as to why [the issuer] was on the verge of bankruptcy."[33] Instead, where a company provides disclosure of risks or adverse facts, the subsequent disclosure that an investigation or litigation has commenced, or that a bankruptcy has ensued does not suffice to establish loss causation because it "discloses nothing new, but merely [seeks to] attribute an improper purpose to the previously disclosed facts."[34]

Loss Causation Cannot Be Established Where and to the Extent That the Issuer's Stock Price Collapses Before the Allegedly Concealed Risk Is Revealed

Another basic principle of loss causation is that where the stock price has already collapsed before the "truth" is allegedly revealed, plaintiffs obviously cannot demonstrate the necessary causal connection or state a claim as a matter of logic, much less as a matter of law. Thus, in *Merrill Lynch*, the Second Circuit affirmed the dismissal on loss causation grounds of claims that analysts issued false "buy" recommendations because the stocks dropped in price long before it was revealed that the analysts were misrepresenting their recommendations.[35] Similarly, in *Ray v. Citigroup Global Markets*,[36] plaintiffs claimed to have been injured when the price of the issuer's stock, that had traded as high as $80 per share, "began to collapse" and ultimately fell below $2 per share.[37] Finding that the "truth" about the misrepresentations that allegedly inflated the stock was also alleged to have remained hidden until the end of the class period, well *after* the stock declined, the district court held that no loss causation could be established as a matter of law.[38]

Loss Causation Cannot Be Established Where the Issuer's Stock Price Does Not Decline Upon Disclosure of the "True Facts"

Loss causation also cannot be shown where plaintiffs cannot "point to a sharp drop in the company's stock price following announcement of the allegedly concealed truth."[39]

In *In re The First Union Corp. Sec. Litig.*, plaintiffs challenged various statements concerning the success of First Union's acquisition of The Money Store and the gain-on-sale accounting benefits of that transaction.[40] The stock price declined during the class period due to disappointing earnings unrelated to the performance of The Money Store or its gain-on-sale accounting. When it was later disclosed that the acquisition was a bust and that a huge write-off and reversal of the gain-on-sale accounting benefits would be required, First Union's stock price actually rose.[41] Under those circumstances, the *First Union* court held that plaintiffs had not pleaded – and could not plead – facts linking the earlier drop in stock price to "the truth [that was allegedly misrepresented] mak[ing] its way into the market place."[42]

In conclusion, despite some initially discouraging signs, defense practitioners have several strong arguments to attack faulty loss-causation arguments. In fact, as shown above, many courts have recognized that law and logic demand more rigorous examination of plaintiffs' loss-causation pleadings.

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Endnotes

[1] *Id.* at 1634.

[2] *Id.* at 1632.

[3] *Bastian v. Petren Res. Corp.*, 892 F.2d 680, 684-85 (7th Cir. 1990).

[4] *Lentell v. Merrill Lynch & Co., Inc.*, 396 F.3d 161, 174 (2d Cir. 2005) (quoting *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763, 769 (2d Cir. 1994)).

[5] *Merrill Lynch*, 396 F.3d at 175.

[6] *Dura*, 125 S. Ct. at 1633.

[7] *In re Dura Pharms, Inc. Sec. Lit.*, Civil No. 99cv0151-L(NLS), slip op. at 15-19 (S.D. Cal. June 2, 2006).

[8] *Id.* at 16 (citing Dura, 544 U.S. at 346); *see also id.* at 17.

[9] *Id.* at 18 (citing *Dura*, 544 U.S. at 346-47).

[10] *Id.* at 16 (citing *Dura*, 544 U.S. at 346); *see also id.* at 17 ("Under the liberal pleading requirements of Rule 8(a), these allegations are sufficient to meet the loss causation requirement."); *Wojtunik v. Kealy*, No. CV-03-2161-PHX-PGR, 2006 WL 2821564, *3 (D. Ariz. Sept. 30, 2006) (loss causation "need only be alleged so as to meet the 'fair notice' requirement of [Rule 8(A)]"); *CompuDyne Corp. v. Shane*, 453 F.Supp.2d 807, 827 (S.D.N.Y. 2006) (stating that Dura affirmed that "short and plain statement" of loss causation is sufficient). *But see, e.g., In re Glaxo SmithKline PLC Sec. Litig.*, No. 05 Civ. 3751(LAP), 2006 WL 2871968, *13-14 (S.D.N.Y. Oct. 6, 2006) (applying Rule 9(b) and heightened pleading requirements to all elements of securities fraud); *In re StockerYale Sec. Litig.*, 453 F.Supp.2d 345, 358-59 (D.N.H. 2006) (Dura imposed "relatively strict standard" for loss causation); *In re eSpeed Sec. Litig.*, No. 05 CIV.2091 (SAS), 2006 WL 880045 at *17 (S.D.N.Y. Apr. 3, 2006) (the question of "whether the pleading of loss causation is governed by Rule 8(a) or Rule 9(b) of the Federal Rules of Civil Procedure . . . is an issue left open by *Dura*"); *First Union*, 2006 WL 163616 at *6 (applying Rule 9(b) after determining that *Dura* "expressly declined to consider whether loss causation must be pled with particularity").

[11] *Dura*, 125 S. Ct. 1627 *passim* (reversing reversal of dismissal); *Joffe v. Lehman Bros.*, 410 F. Supp. 2d 187, 194 (S.D.N.Y. 2006) (rejecting allegation that "'as a direct and proximate result of defendants' wrongful conduct,' plaintiffs 'were damaged by the loss' of their investment" as falling "way short of what is required to demonstrate loss causation both under Rule 8 . . . and under *Dura*"); *see also, e.g., In re Eaton Vance Mut. Funds Fee Litig.*, 403 F. Supp. 2d 310, 314 (S.D.N.Y. 2005).

[12] *In re Teco Energy Sec. Litig.*, No. 8:04-CV-1948-T-27EAJ, 2006 U.S. Dist. LEXIS 18101, *13 (M.D. Fla. Mar. 30, 2006).

[13] *Merrill Lynch*, 396 F.3d at 172.

[14] *Merrill Lynch*, 396 F.3d at 173 (quoting *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 95 (2d Cir. 2001)) (emphasis in original).

[15] *See Dura*, 125 S.Ct. at 1630; *see also, e.g., First Union*, 2006 WL 163616, at *5 (rejecting attempts to tie stock drop occurring after earnings disappointment to challenged disclosures concerning ultimately failed acquisition).

[16] *Payne v. DeLuca*, CA No. 02-1927, slip op. at 88, 2006 U.S. Dist. LEXIS 25621, *176 (W.D. Pa. May 2, 2006) ("*Payne II*") (quoting *In re IKON Office Solutions, Inc. Sec. Litig.*, 131 F.Supp.2d 680, 691 (E.D. Pa. 2001)).

[17] *Id.* at 84.

[18] *Id.* at 85-86; *see also id.* at 87-88. But see Dura, Civil No. 99cv0151-L(NLS), slip op. at 15-19.

[19] *Merrill Lynch*, 396 F.3d at 176-77.

[20] *In re Parmalat Sec. Litig.*, 375 F. Supp.2d 278 (S.D.N.Y. 2005).

[21] *Parmalat*, 375 F. Supp. at 307 (emphasis added).

[22] *Glover v. DeLuca*, No. 2:03-CV-0288, 2006 WL 2850448, *35 (W.D. Pa. Sept. 29, 2006).

[23] *Id.*

[24] *See Catton v. Defense Tech. Sys., Inc.*, 2006 WL 27470, at *5 (S.D.N.Y. January 3, 2006) (cited in Recon. Br. at 18).

[25] *Catton*, 2006 WL 27470, at *5 (emphasis added) (quoting *Merrill Lynch*, 396 F.3d at 173-174 and *In re Public Offering Sec. Litig.*, 2005 WL 1529659, at *3-5 (S.D.N.Y. June 28, 2005)).

[26] *Catton*, 2006 WL 27470, at *9.

[27] *Merrill Lynch*, 396 F.3d at 177.

[28] *Glover*, 2006 WL 2850448, at *37.

[29] *Merrill Lynch*, 396 F.3d at 177.

[30] *D.E.&J. Ltd. P'ship v. Conaway*, 133 Fed. Appx. 994, 1000 (6th Cir. 2005).

[31] *Id.* at 1000-01.

[32] *Payne II*, at 86-87.

[33] *Id.* at 87.

[34] *In re Cree, Inc. Sec. Litig.*, No. 1:03CV00549, 2005 WL 1847004, *12 (M.D.N.C. Aug. 2, 2005).

[35] *See Merrill Lynch*, 396 F.3d at 177.

[36] *Ray v. Citigroup Global Markets*, No. 03 C 3157, 2005 WL 2659102 (N.D. Ill. Oct. 18, 2005).

[37] *Id.* at *4.

[38] *Id.; see also e.g., In re Daou Sys. Inc.*, 411 F.3d 1006, 1027 (9th Cir. 2005) ("[A]ny loss suffered . . . before the revelations began in August 1998 . . . cannot be considered causally related to Daou's allegedly fraudulent accounting methods because, the true nature of Daou's financial condition had not yet been disclosed."); *Payne II*, at 87 (Plaintiffs' "claims . . . fail because the loss they sustained occurred before the details of the alleged reckless behavior became generally known"); *Schleicher v. Wendt*, No.1:02 CV 1332 DFHTAB, 2005 WL 1656871 (S.D. Ind. July 14, 2005); (finding no loss causation where "[t]he stock had long since hit bottom before the alleged misrepresentations became known"); *Powell v. Idacorp. Inc.*, No. CV04-249-S-EJL, 2006 U.S. Dist. LEXIS 21831, *12 (D. Id. Mar. 29, 2006) (losses predating curative disclosure "cannot be causally related" to a misrepresentation).

[39] *Schleicher*, 2005 WL 1656871, at *4; *see also Merrill Lynch*, 396 F.3d at 175 (affirming dismissal where plaintiffs failed to demonstrate that the stock price "reacted negatively to a corrective disclosure" at odds with statements being challenged"); *Payne II*, at 83, 87 (dismissing case where plaintiff failed to show "that the share price fell significantly after the truth about the misstatement or omission became known"); *Glaxo SmithKline*, 2006 WL 2871968, 14 (plaintiff "failed to allege a loss at all," given that the share price was higher after the negative disclosure than plaintiff paid).

[40] *In re The First Union Corp. Sec. Litig.*, No. Civ. 3:99CV237-H, 2006 WL 163616 (W.D.N.C. Jan. 20, 2006).

[41] "Plaintiffs . . . allege that the 'truth about The Money Store was revealed' on June 26, 2000, when First Union announced that it would discontinue all home equity lending activities at the Money Store and take an estimated $2.8 billion in restructuring and other charges, which included writing off $2.2 billion for the

Money Store acquisition. It is undisputed that rather than decline, however, First Union's stock price rose six cents (.06) per share that day, and within three weeks, had risen an additional thirty-seven-and-one-half cents ($.375) per share." *Id.* at *3.

[42] *Id. at *5. Cf. Asher v. Baxter Int'l, Inc.*, No. 02-5608, 2006 U.S. Dist. LEXIS 4821 (N.D. Ill. Feb. 7, 2006) (finding loss causation a close call even though "corrective disclosures resulted in a sharp stock price decline); *In Re Immune Response Sec. Litig.*, (the "stock price dropped sharply when the truth [about the misrepresented facts] became public"); *Montalvo v. Tripos, Inc.*, No. 03-995, 2005 WL 2453964 (E.D. Mo. Sept. 30, 2005) (announcement of earnings shortfall – for reasons that would later lead to a restatement – resulted in 61 percent decrease in stock price). ■

Recent Victories

During 2006, Latham prevailed in numerous securities and professional liability matters for clients such as Lehman Brothers, Deutsche Bank Securities Inc., and The Carlyle Group. Among these successes include:

Deloitte & Touche LLP

Latham represented Deloitte & Touche LLP (D&T) in the $12 billion headline-dominating case, which was based on allegations stemming from the investigation of insurance brokers and insurers launched by Eliot Spitzer, the New York Attorney General (NYAG). That investigation uncovered instances of alleged "bid-rigging" or "steering" by brokers at a subsidiary of Marsh & McLennan Cos., Inc. (MMC). MMC settled with the NYAG in January 2005, agreeing to establish an $850 million restitution fund for its clients. The multi-billion dollar stock drop that followed the filing of the NYAG complaint led to the filing of a securities class action in United States District Court for the Southern District of New York against MMC, several of its former officers, and also D&T — MMC's auditors. Among other allegations, Plaintiffs contended that that D&T engaged in securities fraud and other securities law violations by not catching MMC's conduct during its audits, and by allegedly failing to ensure that MMC properly accounted for its "illegal" activities. While other defendants — including MMC — had their motions to dismiss denied, Latham secured the dismissal with prejudice of all counts against D&T, and the 100-page opinion issued by the court granting D&T's motion to dismiss in July 2006 established favorable law for auditors in virtually every area of federal securities law.

National Accounting Firm

Latham successfully defended at trial a national accounting firm against claims of malpractice and breach of contract. Plaintiff, the trustee of a bankrupt technology company in the telecommunications sector, had sued its former officers and directors for breach of fiduciary duty and other securities claims, seeking hundreds of millions of dollars in damages. The claims mirrored similar allegations brought by shareholders in a parallel federal securities class action. Both of those lawsuits were settled. Subsequently, plaintiff sued its independent accountant alleging that the defendant failed properly to conduct an audit and interim review, and failed properly to scrutinize accounting judgments that later were restated, causing in excess of $75 million in damages. Following a nearly three-week arbitration and testimony from more than 15 witnesses, the three-arbitrator panel rendered a complete defense verdict, finding that the accounting firm had properly performed all of its professional duties.

Pan Pacific Retail Properties, Inc.

Latham represented Pan Pacific Retail Properties, Inc. and the former members of its board in multi-jurisdiction corporate control class action litigation arising out of the sale of Pan Pacific to Kimco Realty Corp for $4 billion. In separate shareholder suits brought in California and Maryland, plaintiffs alleged that the defendants breached their fiduciary duties by allegedly engaging in an deficient process and agreeing to sell Pan Pacific for an allegedly unfair price. Latham took the upper-hand in fast paced litigation to defeat plaintiffs' eleventh hour attempt to enjoin the shareholder vote on the merger. We were able to broker a settlement of both lawsuits prior to the vote, overcoming maneuvers by the Maryland plaintiffs to thwart an early settlement by the California plaintiffs.

PricewaterhouseCoopers LLP

Latham won dismissal for PricewaterhouseCoopers LLP (PwC) of a purported billion dollar securities class action in which plaintiffs sued Visteon Corp, several of its officers, and PwC, the independent public auditors of Visteon's financial statements, for claims under Section 10(b) of the Securities and Exchange Act of 1934. Plaintiffs' asserted a 5 year class period dating from Visteon's spin off from Ford Motor Co. in 2000 to January 2005, when Visteon announced a restatement of some of its financial statements. The court granted PwC's motion to dismiss, as well as the motions of the other defendants. As to PwC, the Court found that the plaintiffs failed to allege scienter under 10(b) as a matter of law. Plaintiffs filed a notice of appeal.

Another Assault on the Attorney-Client Privilege? Third Circuit Applies Crime-Fraud Exception to Attorney Advice on Subpoena Compliance

By Alexandra A.E. Shapiro, David M. Brodsky and Sean O'Dowd

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A federal grand jury issues a subpoena *duces tecum* calling for a corporation to produce certain documents. The in-house lawyer charged with subpoena compliance contacts employees who may have responsive documents. The lawyer reviews with each employee the contents of the subpoena and provides instructions and legal advice about document retention and production of responsive documents. The purpose of these communications, initiated by the lawyer, is plainly to make sure that the employees identify and make available all potentially responsive documents.

Are these communications – seemingly classic examples of privileged attorney-client communications – protected by the corporation's attorney-client privilege? Not necessarily, according to an April 2006 Third Circuit decision that appears to expand the scope of the "crime-fraud exception" to the privilege significantly. The case, *In re Grand Jury Investigation*, 445 F.3d 266 (3rd Cir.), *cert. denied*, 127 S. Ct. 538 (2006), invokes the exception to compel an organization's attorney to testify to the substance of his communications with one of the entity's employees, where the government presented evidence that the employee was involved in deleting e-mails in order to obstruct its investigation. The court held that the conversation was not privileged, even though the entity's attorney, and not the employee, had initiated the discussions, in order to help the company to comply with a grand jury subpoena.

That attorney-client communications made "in furtherance of" a future or ongoing crime or fraud may not be shielded by the privilege, of course, is not new law. The crime-fraud exception traces its roots to British common law of the 1700s.[1] It was recognized by the US Supreme Court as early as 1891, when the Court stated in *dicta* that "if a client *applies to a legal adviser* for advice intended to facilitate or to guide the client in the commission of a crime or fraud, the legal adviser being ignorant of the purpose for which his advice is wanted," then the communication is not privileged.[2] The exception exists, according to Wigmore, because the rationale for the privilege "ceas[es] to operate at a certain point, namely, where the *desired advice* refers not to prior wrongdoing, but to future wrongdoing."[3] Moreover, as will be discussed further below, these and other leading authorities recognize the exception even where the attorney is ignorant of the fraud, but the premise in such cases seems to be that the *client* sought the advice to further the crime.

The underlying facts in *In re Grand Jury Investigation* are somewhat obscure because the Third Circuit describes only minimal details in light of the ongoing grand jury investigation. However, based on what is revealed it appears that the Third Circuit has lowered the bar for piercing the attorney-client privilege on a crime-fraud theory. The case involves a federal grand jury investigation whose initial target was an individual who had certain business dealings with the organization. At some point during the course of this investigation, the grand jury also began to investigate Jane Doe, the organization's executive director, and issued a subpoena *duces tecum* to the organization. The government was not satisfied with the organization's initial response and followed up with a second subpoena to the organization. Just one day later, the government also notified the organization's attorney that it wished to have FBI and IRS experts scan the organization's computers to recover deleted e-mails and other electronic records. After receiving the subpoena and notice, the organization's attorney called Jane Doe to discuss these subjects. Subsequently, an FBI technician took mirror images of the organization's hard drives and uncovered evidence suggesting that employees of the organization, including possibly Jane Doe, had attempted to delete e-mail.[4]

The government later sought to compel production of the lawyer's notes of his conversation with Jane Doe about the subpoena, as well as the lawyer's testimony about the substance of that conversation. The district court ruled that this evidence was not within the ambit of the attorney-client privilege, concluding after an *ex parte* hearing that the crime-fraud exception to the privilege applied. The court found sufficient evidence that, at the time of her conversation with the organization's lawyer, Jane Doe was in the process of committing obstruction of justice and had used the lawyer's advice in furtherance of her crime. The Third Circuit affirmed.[5]

The Court's decision appears to expand the crime-fraud exception to garden-variety corporate attorney-client communications and could undermine the confidentiality on which corporations and their attorneys continue to rely (even in an era when government waiver demands have eroded the privilege in other respects). Although federal courts of appeals had previously invoked the exception in circumstances where the attorney was unaware that the client was contemplating or committing a crime or fraud, none appears to have gone so far as to hold routine legal advice by an entity's lawyers to its employees about subpoena compliance, to be unprotected.[6] Indeed, the Third Circuit acknowledged that its holding was unique: "Concededly, there are no opinions of which we are aware that apply the crime-fraud exception in precisely these circumstances."[7]

Previous federal court of appeals decisions compelling disclosure of attorney-client communications based on the crime-fraud exception appear generally to fall into one of three categories: (1) cases in which the client sought the advice or assistance of an attorney with the intent of furthering a fraud or other crime;[8] (2) cases in which the attorney submitted false information on behalf of the client, to another party, a government agency or a court;[9] and (3) cases in which the attorney was knowingly involved in the client's wrongdoing (and in some cases actually induced or encouraged the client to engage in the crime or fraud).[10] *In re Grand Jury Investigation* does not fit into any of these categories. The first does not apply because Jane Doe did not solicit or initiate the communication with the intent to commit a crime; she received unsolicited advice from the organization's lawyer. As for the second, the attorney transmitted no information on behalf of Jane Doe. Nor does the advice fit within the third category because there was "no suggestion that Attorney did anything improper in transmitting this communication to Jane Doe and providing legal advice on how to respond" or "that Attorney was aware of either past wrongdoing or potential future wrongdoing." *Id.* at 279.

One of the most striking aspects of the opinion is that the Third Circuit specifically rejected the argument that the crime-fraud exception did not apply because the employee, Jane Doe, did not initiate the conversation with the attorney or solicit his advice. Doe pointed out that in an earlier Third Circuit decision, *United States v. Doe*, 429 F.3d 450 (3rd Cir. 2005), the court stated that "[o]nly when a client *knowingly seeks* legal counsel to further a continuing or future crime does the crime-fraud exception apply." *Id.* at 454 (emphasis added). However, the *In re Grand Jury Investigation* court brushed this point aside, asserting that the sentence in *Doe* merely "reflects the facts of that case." The court concluded, without citation or analysis, that "[n]othing in [*Doe*], or in any opinion, suggests that the crime-fraud exception applies only if the client initiates the conversation." 445 F.3d. at 274.

The Third Circuit's language in *Doe* about the need for the client to seek out legal advice was actually more faithful to precedent applying the crime-fraud doctrine than is its statement in *In re Grand Jury Proceedings*. In each of the published court of appeals decisions applying the doctrine in the first category described above, the communication was initiated by the client, who engaged in some affirmative act to elicit the assistance or advice of the attorney to effectuate a crime or fraud. (As noted above, the second and third categories are irrelevant to the communications at issue in *In re Grand Jury Investigation*.) Courts have also emphasized that attorney-client communications are not subject to disclosure under the crime-fraud exception unless they "actually *have been made with an intent* to further an unlawful act." *United States v. White*, 887 F.2d 267, 271 (D.C. Cir. 1989) (emphasis added).[11] There would be no need to require that the client engaged in the communication with a criminal purpose and that "the wrong-doer had set upon a criminal course *before* consulting counsel," *United States v. Jacobs*, 117 F.3d 82, 88 (2d Cir. 1997) (emphasis in original), however, if the exception could be invoked even where a communication is initiated by a company's attorney for the innocent purpose of assisting the company in satisfying its legal obligations.

Moreover, some of the seminal authorities on the crime-fraud exception contain language supporting a client-initiation requirement in cases where the attorney is unaware of the crime or fraud. For example, in *United States v. Zolin* the Supreme Court opined that the exception applies only to "'*communications made for the purpose of getting advice* for the commission of a fraud or crime.'" 491 U.S. 554, 563 (1989) (emphasis added) (citation omitted). In Supreme Court Standard 503, which Judge Weinstein has described as "a powerful and complete summary of black-letter principles of lawyer-client privilege," it states that the privilege does not apply "[i]f the services of the lawyer *were sought or obtained* to enable or aid anyone to commit or plan to commit what the client knew or reasonably should have known to be a crime or fraud."[12] The "sought" and "obtained to" language suggest that a purposeful act by the client is required. Moreover, the Third Circuit's opinion in *Doe*, on its face, plainly limits the application of the crime-fraud exception to cases where the client "*knowingly seeks* legal counsel" to further an illegal act, notwithstanding the holding of *In re Grand Jury Investigation*.[13]

The extent to which the Third Circuit's decision will actually lead to compelled disclosure of classic subpoena compliance advice by a corporation's attorneys remains to be seen. Even if the decision is given a broad reading, however, attorneys responsible for overseeing an entity's compliance with a government subpoena cannot responsibly fail to give advice regarding the interpretation and scope of subpoenas; they must continue to take prudent and reasonable steps to ensure that the entity preserves and produces responsive documents – including discussing the contents of the subpoena with employees while providing appropriate legal advice relating to the subpoena.

It is possible that the expansive language in *In re Grand Jury Investigation* will ultimately be narrowed in some way. Perhaps the egregiousness of the alleged obstruction, as described at the *ex parte* hearing but not made public, is what drove the unusual result in the case. Another potential basis for reading the opinion narrowly is that the government was unsatisfied with the organization's compliance with its first subpoena, and took the unusual step of issuing not only a second subpoena but also a request to send a forensic expert to excavate deleted computer files and e-mails. A corporate attorney who learns that the government believes that responsive documents have been withheld or destroyed should exercise discretion in sharing that information with employees whom the government may suspect are involved in efforts to obstruct justice. In such a situation, the attorney may even wish to consider seeking the government's advice as to the most prudent way to comply with a subpoena or other request for information without jeopardizing the integrity of the investigation.

Endnotes

1 *See* David J. Fried, *Too High a Price for Truth: The Exception to the Attorney-Client Privilege for Contemplated Crimes and Frauds*, 64 N.C. L. REV. 443, 445 & n. 16 (1986)

2 *Alexander v. United States*, 138 U.S. 353, 359 (1891) (emphasis added).

3 8 Wigmore, Evidence § 2298 (McNaughton rev. 1961) (emphasis added) (quoted in *United States v. Zolin*, 491 U.S. 554, 562-63 (1989)).

4 445 F.3d at 268.

5 *Id.* at 280.

6 A complete review is not possible, because many cases, particularly those arising in the context of grand jury proceedings, omit or truncate discussion of the underlying facts.

7 445 F.3d at 278.

8 *See, e.g., United States v. Edwards*, 303 F.3d 606 (5th Cir. 2002) (defendant hired attorney for purpose of concealing bribery and fraud); U.S. v. Reeder, 170 F.3d 93 (1st Cir. 1999) (defendant asked lawyer for help in covering up his fraudulent use of insurance company money); *United States v. Under Seal (In re Grand Jury Proceedings)*, 33 F.3d 342 (4th Cir. 1994) (clients were engaged in illegal conduct when they sought legal counsel and used attorneys to perpetuate criminal or fraudulent behavior); *In re Grand Jury Subpoena 92-1 (SJ)*, 31 F.3d 826 (9th Cir. 1994) (corporation sought assistance of counsel in obtaining export licenses, one of which was used to facilitate export scheme involving dummy corporation); *Doe v. U.S.*, 13 F.3d 633 (2d Cir. 1994) (client sought to "solicit the assistance of an attorney in the commission of a crime"); *U.S. v. Inigo*, 925 F.2d 641 (3rd Cir. 1991) (client hired attorney specifically to help further ongoing extortion); *In re Grand Jury*, 845 F.2d 896 (11th Cir. 1988) (defendants obtained advice of unknowing counsel for the purpose of tampering with jury).

9 *See, e.g., United States v. Under Seal*, 102 F.3d 748 (4th Cir. 1996) (innocent attorneys legitimized client bank's crime or fraud by using false date on correspondence and statements); *U.S. v. Chen*, 99 F.3d 1495 (9th Cir. 1996) (innocent attorneys transmitted fraudulent information to Customs officials as part of tax evasion scheme; clients used attorneys' prestige in Customs bar to shield their guilt); *United States v. Collis*, 128 F.3d 313 (6th Cir. 1997) (lawyer submitted client's forged letter of recommendation to court); *United States v. Edgar*, 82 F.3d 499 (1st Cir. 1996) (attorney submitted false income tax return and fraudulent demand letter provided by client); *United States v. Laurins*, 857 F.2d 529 (9th Cir. 1988) (attorney transmitted false information to IRS on behalf of client); *In re Sealed Case*, 676 F.2d 793 (D.C. Cir. 1982) (attorneys prepared affidavit in which client may have lied); *In re Berkeley & Co.*, 629 F.2d 548 (8th Cir. 1980) (company lawyer was involved in filing documents relating to alleged customs fraud).

10 *See, e.g., In re Grand Jury Proceedings*, 417 F.3d 18 (1st Cir. 2005) (attorney "directed his client to commit perjury, after initially advising him to tell the truth"); *White v. American Airlines*, 915 F.2d 1414 (10th Cir. 1990) (outside counsel for company repeatedly requested that company vice president perjure himself, thus vitiating company's privilege); *In re Sealed Case*, 754 F.2d 395 (D.C. Cir. 1985) (Synanon Church began campaign of perjury and massive evidence destruction at the direction and with the knowledge of the church's lawyers, who essentially served as "front men" in scheme to defraud government); *United States v. Martin*, 278 F.3d 988 (9th Cir. 2002) (after defendant created sham company, he hired lawyer to be sham general counsel); *In re Grand Jury Proceedings*, 680 F.2d 1026 (5th Cir. 1982) (criminal defendant was told by conspirator that he would be "taken care of" if arrested, so lawyer's subsequent provision of legal services paid for by third party was part of explicit conspiracy); *United States v. Ballard*, 779 F.2d 287 (5th Cir. 1986) (client entered into financial arrangement where he deeded property to his attorney, in part to avoid tax lien); *United States v. Horvath*, 731 F.2d 557 (8th Cir. 1984) (lawyer conducted transactions in support of client's business selling illegal drugs).

11 *See also In re Grand Jury Subpoenas Duces Tecum*, 798 F.2d 32, 34 (2d Cir. 1986) (exception applies "only when there is probable cause to believe that the communications with counsel *were intended* in some way to facilitate or conceal the criminal activity") (emphasis added).

12 Supreme Court Standard 503(d)(1), reprinted in Jack B. Weinstein & Margaret A. Berger, *Weinstein's Evidence Manual* § 18.03[1], at 18-16 (emphasis added).

13 *See* 429 F.3d at 454 (emphasis added). ■

Out In Front:

Recent and Upcoming Seminars and Speaking Engagements

- Latham hosted a number of General Counsel Forum events addressing stock option practices. These took place across the US in Chicago, San Diego, Los Angeles, New York, Silicon Valley and San Francisco. To date, more than 50 companies have been the target of investigations by the Justice Department, SEC and the IRS into stock option back-dating processes. Not since the Enron scandal have we seen this kind of media attention and companies are preparing for the worst. This program addressed the current status of options timing litigation and accounting and enforcement activities, likely new SEC disclosure rules on option grant practices, option grant best practices and the impact of option issues on private companies, IPOs and follow-on offerings. Latham speakers included Mark Gerstein, Robin Struve, Bob Tarun, Jim Barrall, Pamela Palmer, Steven Stokdyk, David Brodsky, Steven Della Rocca, Bradd Williamson, Alexandra Shapiro, David Barby, Scott Shean, Rob Burwell, Tracy Edmonson, John Tang, David Friedman, Joseph Yaffe, Paul Dawes and Peter Kerman.

- Partner Laurie Smilan was the key note speaker at the Fall 2006 KPMG Audit Committee Roundtable. The event took place November 29 in Orlando, FL.

- **Electronic Discovery: Understanding the New Rules Effective December 1, 2006 (Multi-city)**

  Latham hosted a series of seminars on the new e-discovery amendments to the Federal Rules of Civil Procedure that went into effect December 1, 2006. The forum analyzed and explained the new rules, including the new provisions governing initial disclosures, the Rule 26(f) discovery conference, and the so-called "safe harbor" provision of Rule 37(f). Topics of discussion also included how new amendments bear on current "best practices" for e-discovery, and will debunk a number of common misperceptions about the effect of the new amendments. Latham speakers included Juli Marshall, Robin Hulshizer, Kathy Lauer, Tim O'Mara, Jim Lynch, Dick Ulmer, John Tang, Peter Devereaux, Pamela Palmer, Jon Anderson, Mike DeVries and David Brodsky.

- Greg Feder was a featured speaker at the 2006 Capital Markets Compliance Fundamentals Workshop on a panel entitled "Overview of Banking/Securities Law and Regulatory Structure." The conference was hosted by the Financial Markets Association and provided an introduction to securities dealer's activities of banks or their affiliated firms. The workshop was held December 6-8, 2006 in Washington, D.C.

- Latham was a sponsor of the KPMG Audit Committee Roundtable, "An Audit Committee Imperative: Understanding How It All Fits Together." Bill O'Neill was a featured speaker. The roundtable explored leading practices used by audit committees to ensure proper alignment and coordination of their oversight activities. Discussions also included what boards need to know about the audit committee's oversight activities, including leading practices in audit committee communications with the full board and other board committees. The roundtable was held December 7, 2006 in Tyson's Corner, VA.

- Sean Berkowitz moderated a panel entitled "Practical Lessons Learned from the Enron Trial – What General Counsel Can Learn from the Fall of Enron" at a conference is hosted by Navigant Consulting. The roundtable was held December 12, 2006 in Chicago.

- Olivier du Mottay, Christian Nouel and Charles Antoine Guelluy were the featured speakers at a Stock Options Seminar entitled "Stock Options – Free Granting of Shares: Has the Situation Changed Following the Enactment of the French Statutes on Profit-Sharing and Employee Shareholding?" The seminar was held December 12, 2006 in Paris.

Out In Front: *Recent and Upcoming Seminars and Speaking Engagements*

- Patrick Dunaud and Basil Zotiades were co-presenters of several awards at the "14th Edition of the European Financial Analyst Awards" co-sponsored by the *Wall Street Journal* and *Financial News*. The ceremony was held December 13, 2006 in Paris.
- Bill Baker was a featured panelist at a conference on the Department of Justice's memorandum on when to charge corporations criminally. The panel addressed the impact of the McNulty Memorandum on the SEC's decision to waive attorney-client privilege. The conference was hosted by the Practicing Law Institute in New York on January 19, 2006. The event was also presented as a live webcast.
- Jamie Wine was a featured speaker at CLE International's annual Class Action Conference where she presented on electronic discovery issues and the impact of the e-discovery amendments to the Federal Rules of Civil Procedure. The conference was held in Los Angles, on January 25, 2007.

Upcoming

- Sean Berkowitz and Zachary Fardon will moderate the panel "Hard Lessons for Every Lawyer: *What You Need to Know about White Collar Crime in the Post-Enron World.*" The panel will include insider views of the Enron case, the evidence at trial and why Jeffrey Skilling was found guilty. The discussion will also include perspectives on lessons learned from the fraud trial against former Illinois Governor George Ryan. The event is sponsored by PricewaterhouseCoopers and will be presented on February 15 and 16, 2006 in Chicago. For more information, please contact Joyce Simon (+1 312 876-7604).
- David Schindler and Sean Berkowitz are featured speakers on the opening panel of the ABA 2007 White Collar Crime National Institute conference. The panel, entitled "Lessons Learned from Recent Major Fraud Prosecutions." will include discussions on the three most high-profile trials in the past year: Enron, Tenet Healthcare and Governor Ryan. Panelists will explore the key pre-indictment, evidentiary, trial and additional issues that arose in those cases. The conference will be held March 1-2, 2006 in San Diego. For more information, please contact Lisa Easterly (+1 619-238-2817).
- David Brodsky and Bill Baker will be featured panelists at the annual 2007 SIA – Compliance and Legal Division seminar. Mr. Brodsky will speak on the panel "Handling a Litigation or Regulatory Crisis." This session will include a discussion on developments in industry wide class actions, the impact of regulatory proceedings on civil litigation, settlement strategies, and how to manage reputational risks (both external and internal communications). Mr. Baker's panel, "Understanding Control Risks," will focus on demystifying risk assessments, what regulators are looking for, the relationship between enterprise risk management and compliance risk programs, and establishing new product review and approval. The conference takes place March 25-28, 2006 in Phoenix. For more information, please contact Maiya Shaw (+1 415-395-8293).

Circuit and State Round-Up

First Circuit

Happ v. Corning, Inc., 466 F.3d 41 (1st Cir. 2006)

In a case about the rights of directors seeking indemnification for legal defense costs, the First Circuit Court of Appeals ruled that an agreement that a director re-pay legal defense costs under certain circumstances was not obtained under improper financial duress. The agreements, called undertakings, are commonly sought as a condition to advancing defense costs to an officer or director who is involved in litigation or an investigation related to his/her corporate duties. The agreements require the officer or director to repay the amounts advanced if it is "finally determined" that the officer or director engaged in fraud, insider trading or other conduct opposed to the best interests of the company. In this case, the director was advanced almost $900,000 during an Securities and Exchange Commission investigation into whether he had engaged in insider trading. A jury eventually found the director civilly liable for insider-trading, and the company sought repayment of the advanced fees. The director, however, argued that the undertaking was obtained under duress. The First Circuit disagreed and held that duress could not be found where the undertaking represents a plausible interpretation of the party's rights under the governing law, in this case Delaware indemnity law. However, the Court noted that the result "would be otherwise if [the Company's] legal position were absurd or otherwise evidently taken in bad faith."

Blake v. Friendly Ice Cream Corp., 2006 WL 1579596 (Mass. Super. May 24, 2006)

In an important decision applying Massachusetts law, the state Court sent a strong message that more than just economic independence is required for members of a Board's Special Litigation Committee. In this case, the Court rejected a Special Litigation Committee's (SLC) motion to dismiss a shareholder derivative suit because the SLC appointed to investigate the claims failed to exercise actual independence in evaluating those claims.

The suit was brought by a major shareholder, who alleged that Donald Smith, the Chairman and CEO of Friendly Ice Cream Corp. and a related management company, had engaged in mismanagement and self-dealing, including the use of a private jet. The SLC appointed to investigate the claims retained outside counsel, conducted a three-month investigation and issued a 29-page report. The SLC then intervened and moved to dismiss the claim after the investigation concluded the claims lacked merit, but the Court denied the motion.

First, although the SLC member in question had no significant business, economic, personal, family or other social dealings with Friendly, the Court concluded that he was not independent because he had occupied a position on many of the subcommittees that exercised direct oversight over the conduct Plaintiff had challenged. In addition, and perhaps more importantly, the Court analyzed the director's performance on an earlier but related SLC and noted that neither he, nor the other members, sought adequate information or documentation regarding the costs associated with the Learjet. Instead, the Court noted that the director relied entirely upon arrangements made by Friendly's management, including the CEO and Chairman. The director "remained oblivious" and failed to apprise himself of "reasonably available, material facts" about the transactions in question. In sum, his "unreasonable and unwarranted" reliance upon representations of Friendly's management, as well as his own participation in the challenged transactions, defeated a finding of independence.

The Court also determined that two of the three directors who appointed the SLC lacked independence. The Court found that one director exhibited a "stunning degree of ignorance, whether feigned or real, about the transactions material to the plaintiff's allegations," while another showed a "lack of concern [and] failure to inform himself reasonably or adequately about material aspects of related party transactions[.]" The Court found that the SLC was not appointed by independent directors, and therefore its motion to dismiss the complaint failed.

Second Circuit

De Vries v. Tower Semiconductor, Ltd., 449 F.3d 286, (2d Cir. 2006)

Addressing important issues regarding the authority of the Securities and Exchange Commission, the Second Circuit Court of Appeals rejected a challenge to the Commission's ability to exempt foreign issuers from liability under Sections 14(a) of the Exchange Act. Dissenting shareholders of an Israeli corporation, Tower Semiconductor, Ltd., filed suit after the company gained shareholder approval to amend several contracts with institutional investors. The dissenting shareholders claimed that Tower had violated Sections 14(a) and 20(a) of the Exchange Act, and Rule 14a-9, by issuing a misleading proxy statement to gain shareholder approval. The District Court rejected plaintiff's argument the Commission overstepped its authority under Section 12(h) in adopting Rule 3a12-3, which exempted certain foreign issuers like Tower from liability.

The Second Circuit first clarified that it had primary jurisdiction to review objections to rules promulgated by the Commission. The court reasoned that the plaintiff's claim turned on statutory interpretation, and thus fit the "conventional experience of judges" as opposed to "technical or policy considerations within the agency's particular field of expertise." Furthermore, because the "the Commission would normally not be expected to rule on whether it had exceeded its own statutory authority," it did not matter that the plaintiff had made no prior application to the agency.

After clarifying its own authority, the court ruled that Congress, in enacting Section 12(h), intended to provide the Commission "considerable regulatory discretion" to grant exemptions for policy reasons, including exemptions that could reduce the level of investor protection. The court found that "the Commission [could] create exemptions from § 14(a) unconditionally, provided that it determine[d] that such exemptions are not inconsistent with the public interest and the protection of investors." Reviewing the text of the statute and related provisions, the court determined that Section 12(h) did not heighten the standard for authorizing exemptions, but rather overlapped with Section 3(a)(12)(A)(vii) and expanded the scope of the Commission's exemption authority. Given the Commission's rulemaking authority, the Commission provided an "adequate statement of basis and purpose" to support the exemption for foreign issuers, even though the court noted that the release accompanying the rule was "in the Commission's own words, 'fairly brief,' and even that characterization is charitable."

In Re Prestige Brands Holding, Inc., No. 05 CV 06924(CLB), 2006 WL 2147719 (S.D.N.Y. July 10, 2006)

The Southern District of New York ruled that a private equity firm's stock sales in an IPO do not suggest fraud on behalf of the firm or its principals because "[e]arly investors and promoters routinely sell stock in IPOs."

The decision came in a case in which plaintiffs had alleged that Prestige Brands Holding, a distributor of brand name medicines and personal care products, improperly recognized revenue on sales where the customer had a right of return. In addition to the company, its officers and directors, the plaintiffs had named as a defendant a private equity firm with a major investment in Prestige Brands.

The court dismissed the complaint because plaintiffs failed to show that the firm or its principals intended to defraud investors. In the words of the court, "Plaintiffs contend only generically that [the firm] had a motive to commit fraud because it sold some of its stock in connection with the IPO." The court held that stock sales in an IPO are not "unusual or suspicious" and therefore fail to raise an inference of scienter, or the intent to defraud. Moreover, the firm retained more than 18 million shares of the company's stock after the IPO, negating any inference of wrongful intent.

Third Circuit

Benak v. Alliance Capital Management, 435 F.3d 396 (3rd Cir. 2006)

In a ruling that has the potential to extend the time for a mutual fund investor to bring securities fraud claims related to the fund's investment in an issuer, the Third Circuit held that the one-year statute of limitations does not begin to run as soon as unfavorable news about the issuer becomes public, as it does for direct investors in the issuer.

Investors in the mutual fund Alliance Capital Management L.P. (Alliance) sued the advisers of the fund, alleging securities fraud, related to its investments in Enron Corp. Alliance held investments in Enron before its collapse on December 2, 2001, and continued to increase those investments right up until Enron filed for bankruptcy. The investors argued that in light of these investments, Alliance's publicized statements regarding its investment strategies were materially misleading.

The statute of limitations for filing a securities fraud complaint is, according to 15 U.S.C. §78i(e), one year after discovery or reasonable diligence should have discovered the facts constituting the violation. The investors filed suit on December 13, 2002, more than a year after Enron filed for bankruptcy.

The Third Circuit held that, because a mutual fund investor has less reason than a direct investor to monitor the health of the fund's investments, or even know all the companies in which the fund's invested, the one-year statute of limitations would not begin until the mutual fund investor should realize that (a) news about a company could indicate an injury to its investors, and (b) the mutual fund had in fact invested in that company. Such information might take more than a year from the time of the issuer's downfall to discover.

In re AT&T Corporation, 2006 WL 2021033 (3rd Cir. 2006)

In a ruling on the reasonableness of attorneys fees, the Third Circuit denied a challenge by certain shareholder class members that a fee award of $21 million to plaintiffs' counsel in a securities fraud action was not excessive. In 2000, several plaintiffs filed securities fraud actions against AT&T, alleging violations of 10(b) and 20(a) and Rule 10b-5. The case went to trial in 2004, and was settled during the trial. AT&T agreed to pay the class $100 million, and attorneys' fees would be paid to class counsel in the amount of 21.25 percent of the settlement fund, or $21.25 million. Eight members of the potential class of more than one million filed objections. They argued that the award was unreasonable because it was (1) excessive, (2) wrongly imposed a sliding scale that increases, rather than decreases, the fee as the settlement amount increased, and (3) provided for full payment for the attorneys before class members would receive payment.

The Third Circuit upheld the District Court's award. The $21.25 million was 1.28 times the amount that would have been awarded using a lodestar calculation, which is the number of hours spent by the attorneys times a reasonable hourly billing fee. The Third Circuit approved of the District Court's assessment that a multiple of 1.28 was reasonable, particularly given the complexity of the case.

Gavin v. AT&T Corp., 464 F.3d 634 (7th Cir. 2006)

The Seventh Circuit's recent decision in *Gavin v. AT&T Corp.* somewhat limited the reach of the Securities Litigation Uniform Standards Act of 1998. That law, commonly called SLUSA, provides some protection for defendants by preventing plaintiffs from bringing securities fraud class actions in state court to avoid the stricter federal requirements of the landmark 1995 Private Securities Litigation Reform Act. SLUSA allows defendants named in state law class actions to transfer the case to federal court and seek dismissal of any claims brought under state law that allege fraud "in connection with" the purchase or sale of a security. Here, following the acquisition of MediaOne Group, Inc., by AT&T, a small class of claimants sued AT&T and a shareholder management company in Illinois state court, alleging state law fraud claims after the defendants failed to tell the shareholders that they could exchange for free their MediaOne shares for AT&T shares. AT&T invoked SLUSA preemption to remove the case to federal court where it was promptly dismissed as a class action "in connection with" the purchase or sale of a security. However, the Seventh Circuit reversed and sent the case back to state court, holding that the case concerned only the method of exchanging shares after the acquisition, which was not sufficiently "in connection with" the sale or purchase of the stock. Judge Richard Posner, writing for a unanimous panel of the Court, opined that the alleged omission was no more "in connection with" the sale of a security than would be the question "do you want your AT&T shares sent to you by regular mail or by courier?" In effect, Judge Posner limited the reach of SLUSA by requiring a close connection between the alleged fraud and the sale or purchase of a securities, such as efforts to manipulate the prices of securities, failure to make full disclosures, or some other concern of the federal securities law.

Ninth Circuit

Simpson v. AOL Time Warner, 2006 WL 1791042 (9th Cir. June 30, 2006)

In *Simpson*, plaintiffs sued Homestore.com and six outside defendants, including AOL Time Warner and Cendant Co., alleging securities fraud by overstating Homestore's reported revenues. According to plaintiffs, Homestore entered into "triangular transactions" in which Homestore.com entered into an advertising reseller agreement with AOL and then contracted with third-party vendors to purchase advertising on Homestore.com through AOL in exchange for Homestore purchasing products from the vendors. Similarly, plaintiffs alleged that Homestore purchased Move.com from Cendant, for what the plaintiffs alleged was a "grossly" excessive price, and in return Cendant purchased products and services from Homestore.

The District Court dismissed the claims against the outside defendants and the Ninth Circuit affirmed, because plaintiffs did not allege a valid claim for primary liability under "any theory of liability." In its ruling, the appellate court held that "to be liable as a primary violator under § 10(b) for participation in a 'scheme to defraud,' the defendant must have engaged in conduct that had the *principle purpose and effect* of creating a false appearance of fact in furtherance of the scheme" and not merely "an accidental effect" [emphasis added]. Thus, the court explained, conduct that "does not have a principal legitimate business purpose" might in fact have the "principle purpose of creating a false appearance" in violation of § 10(b) whereas "participation in a legitimate transaction" without a deceptive purpose or effect will not allow for a primary violation even if the defendant anticipated that another party would "manipulate the transaction to effectuate a fraud." In addition, the court held that a defendant's conduct must be viewed alone and not evaluated in the context of the fraud as a whole.

Deephaven Private Placement Trading, LTD v. Grant Thornton & Co., 454 F.3d 1168 (10th Cir. 2006)

Grant Thornton issued an unqualified audit opinion on Daw Technologies, Inc.'s (Daw) financial statements in 1999. The opinion stated that it was based on audits which were conducted in accordance with GAAP, and that Grant Thornton believed the audits provided a reasonable basis for the unqualified opinion. Beginning in November 2001, Daw made a series of disclosures informing investors that the 1999 financial statements would need to be restated due to accounting problems with its European operations. The plaintiff then sued Grant Thornton, alleging the auditors made materially false and misleading statements by issuing an unqualified opinion in 1999. The Tenth Circuit Court of Appeals affirmed the lower court's dismissal of the case on the pleadings because the plaintiff failed to allege how the auditors' opinion was false and failed to show Grant Thornton was reckless in issuing the opinion. The Court held that a plaintiff who contends that an auditor's opinion is false or misleading must specifically plead (1) that the auditor did not form its opinion based on its audits, or (2) the auditor did not have a reasonable basis for its opinions because it failed to perform the audits in accordance with GAAP. Because an auditor's opinion is not a statement of absolute fact or a guarantee, GAAP violations in financial statements do not by themselves render a auditor's opinion materially false and misleading.

Delaware

Stone v. Ritter, 911 A.2d 362 (Del. Supr. 2006)

In this carefully watched case on director liability for failure to exercise oversight responsibilities, the Delaware Supreme Court expressly adopted the so-called "Caremark standard" set forth in the 1996 decision, *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996). The case concerned a civil complaint for breach of duty against the directors of AmSouth bank, in which the plaintiff alleged that the directors failed to exercise oversight over the bank's compliance with applicable banking laws.

Affirming dismissal of the case against the directors, the Court held that directors can be held liable under either of the following theories: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, the directors consciously failed to monitor or oversee its operations. Second, the Court noted that a director who failed to exercise his or her oversight duties in this way has not acted in good faith and would be liable for a breach of the duty of loyalty, noting that breaches of loyalty were not limited to cases involving direct financial self-interest, but can also be implicated when a director does not act with "the good faith belief that her actions are in the corporation's best interest." Having articulated these standards, the Court concluded that the Board in this case had relevant policies and procedures in place, and there were no "red flags" that should have led the Board to believe that their compliance policies and procedures were deficient in any way. As a result, the complaint failed to allege particularized facts that created a reasonable doubt that the directors had acted in good faith in exercising their oversight responsibilities, and the dismissal of the complaint was affirmed.

In re The Walt Disney Derivative Litigation, 906 A.2d 27 (Del. Supr. 2006)

In this much anticipated decision, the Delaware Supreme Court unanimously affirmed the Court of Chancery's decision in its entirety, holding that neither former Disney President Michael Ovitz nor the Disney directors breached any fiduciary duty nor did they waste the assets of the corporation in connection with the approval of Ovitz's compensation/severance package. The Board paid Ovitz $140 million in severance benefits.

The Court addressed the plaintiff's contentions on appeal in two groups: claims against defendant Ovitz and claims against the Disney directors, including CEO Michael Eisner.

The plaintiffs made two new arguments in their appeal of the Court of Chancery's ruling that Michael Ovitz breached no fiduciary duty in the negotiation and execution of his employment agreement. First, plaintiffs argued that Ovitz was a *de facto* fiduciary during his employment negotiations, although he had not yet entered into a formal relationship with the company. The Supreme Court rejected this new contention as procedurally barred because it was never made before the Court of Chancery and further noted that the claim lacked merit. Delaware law recognizes that *a de facto* fiduciary may owe fiduciary duties despite lacking *de jure* legal title to an office, however, the Court upheld the Chancellor's factual finding that Ovitz's activities prior to formally assuming the office of President were *preparations* for assuming the office rather than the *performance* of the functions of the office. Plaintiffs argued in the alternative that Ovitz violated his fiduciary duties in the negotiation of his employment contract because the contract was not finalized until several weeks after Ovitz took office. The Court of Chancery had found that the critical terms of the contract, however, were in place prior to Ovitz's assumption of a fiduciary role and that subsequent changes to the agreement were not material. The Supreme Court upheld this conclusion. The Supreme Court also held Ovitz had no fiduciary duty to demand, and no factual basis for demanding, a for-cause termination of his employment.

Plaintiffs attempted to structure their claims against the Disney directors so as to circumvent the availability of director exculpation under Disney's § 102(b)(7) provision. By arguing that the directors' breach of the fiduciary duty of care deprived them of the protection of the business judgment rule, plaintiffs attempted to shift to defendants the burden of establishing the entire fairness of the Ovitz employment and termination actions. Plaintiffs claimed the defendants were unable to carry the burden of showing entire fairness and that their breach of the duty of good faith therefore deprived them of the protection of the exculpatory provision.

In response to plaintiffs' allegations, the Supreme Court offered clarification on certain procedural questions regarding the interplay of the business judgment rule and Section 102(b)(7) of the DGCL. Plaintiffs argued that the Court of Chancery "conflated" their effort to rebut the business judgment rule with due care and good faith claims with an analysis of director liability under Disney's 102(b)(7) provision. The Supreme Court held that because a finding of bad faith would both rebut the business judgment rule and preclude exculpation, there is no need to consider the questions separately. Allegations of bad faith are therefore relevant first in the context of an effort to rebut the presumptions of the business judgment rule; should a plaintiff fail to carry this burden, a court need not consider bad faith allegations again in the 102(b)(7) context.

The Supreme Court next considered plaintiffs' argument that the compensation committee failed to exercise due care in its approval of the employment agreement, by contrasting the committee's actual practices with a hypothetical "best case scenario." Although the Court acknowledged the committee's shortcomings, the Court ultimately reaffirmed the principle that the failure to adhere to an ideal standard of conduct does not result in director liability. The Court found the committee as a whole to have been sufficiently informed about the material aspects of the agreement to reach its decision to approve the OEA responsibly.

Perhaps most importantly, the Supreme Court offered clarification on the heretofore mysterious fiduciary duty of good faith. Reviewing the Court of Chancery's finding that the board exercised due care and good faith in approving the hiring of Ovitz as President, the Supreme Court addressed plaintiff's allegations of bad faith and identified three categories of behavior which might implicate the duty of good faith: (1) subjective bad faith where a director is motivated by an intent to do actual harm, (2) actions taken with gross negligence and (3) the category of conduct identified by the Chancellor – "intentional dereliction of duty, a conscious disregard for one's responsibilities." The Court noted that conduct falling under the first category was the most clear-cut example of a violation of good faith. The Court held that the second category, gross negligence without subjective intent, cannot and does not constitute a violation of the duty of good faith. The court described the third category as a "grey area" involving conduct not motivated by conflicting self-interest, yet "more culpable than simple inattention." The Court affirmed the standard articulated by the Chancellor (although describing it as "non-exclusive") and rejected appellant's argument that the Chancellor had modified this standard from an earlier definition. The Court explicitly declined, however, to "define the universe of bad faith" as unnecessary to the issues on appeal.

Having concluded that the Disney board breached no fiduciary duties, the Court turned to plaintiff's two allegations of waste: the approval of the employment agreement by the compensation committee, and the Company's decision to honor the no-fault termination (NFT) severance payment. The Court stated that appellant's claims "do not come close to satisfying the high hurdle required to establish waste" and rejected appellant's first claim by holding that in order for the payment of a contractually negotiated sum to be "waste," the contractual obligation itself must be wasteful. The Court upheld the Chancellor's finding that no waste occurred because the NFT payout, while large, represented only a miniscule percentage of Disney's overall capitalization and was roughly comparable to routine budget allocations for feature film production. Furthermore, the Court held that the NFT provisions in the employment agreement could not constitute waste because they had the rational business purpose of inducing Ovitz to leave a lucrative and secure position at Creative Artists Agency for the uncertainty of Disney, and thereby rejected plaintiff's second waste claim.

SEC

Goldstein v. S.E.C., 451 F.3d 873 (D.C. Cir. 2006)

In this case, the Court of Appeals for the District of Columbia Circuit vacated a Securities and Exchange Commission (SEC) rule that aimed to regulate hedge funds under the Investment Advisers Act of 1940 (IAA or the Act). In December 2004, the SEC adopted a new set of policies, known as the "Hedge Fund Rule," which regulated hedge funds and their managers more tightly than in the past. Pursuant to the Hedge Fund Rule, many hedge fund managers who were previously exempt from the SEC's registration rules for investment advisers were required to register their funds with the SEC.

Traditionally, most hedge funds were exempt from SEC regulation because they had 100 or fewer beneficial owners and did not offer their securities to the public. It was the small, private nature of these hedge funds that exempted them from SEC regulation. Likewise, most hedge fund advisers did not have to register with the SEC, despite the fact that they qualified as investment advisers under the IAA. According to the Act, those who in exchange for compensation engaged in the business of advising others, either directly or through publications or writing, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, were required to register with the SEC unless he or she had fewer than fifteen clients over the last twelve months. The clients of hedge fund advisers were considered to be the funds themselves because the adviser's primary responsibility was to ensure the success of the fund, rather than to advise individual investors on how best to invest their money. Very few hedge fund advisers managed more than fifteen funds; consequently, many of these advisers were exempt from SEC regulation in the past.

With the institution of the Hedge Fund Rule, the shareholders, limited partners, members, and beneficiaries of hedge funds were treated as clients for the purposes of counting the number clients served by a hedge fund adviser over the previous twelve month period. Consequently, many more hedge funds and hedge fund advisers came within the purview of SEC regulation.

The D.C. Circuit, however, vacated the Hedge Fund Rule, saying it was arbitrary in its designation of which funds needed to be regulated and which did not. The court explained that the Hedge Fund Rule did not adequately demonstrate how the relationship between hedge fund investors and advisors justified treating the former as clients of the latter.

The Court held that "client" for purposes of the 15-client rule of the IAA means the fund as a whole, and not the individual investors. The court pointed to language in a 1970 amendment to the Act that indicated Congress did not intend for the shareholders, limited partners, members, or beneficiaries of a hedge fund to be counted as clients. The court stated that the fiduciary relationship normally existing between an investor and his or her individual client exists between the investment adviser and the fund in the case of hedge funds. The court noted that the adviser is concerned with the fund's performance, not with each investor's financial condition. ■

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