SUPREME COURT OF THE STATE OF NEW YORK
APPELLATE DIVISION—FIRST DEPARTMENT

--X

STATE OF NEW YORK and ELIOT SPITZER, Attorney General of the State of New York, for and on Behalf of the People of the State of New York,

Plaintiffs-Respondents,

-against-

N.Y. County Clerk's Index No. 403855/02 (Lowe, J.)

CLARK E. McLEOD,

Defendant-Appellant.

--X

DEFENDANT-APPELLANT CLARK E. McLEOD'S MEMORANDUM OF LAW IN SUPPORT OF HIS MOTION FOR A STAY PENDING APPEAL

ISRAEL RUBIN
GREENBERG TRAURIG, LLP
Met Life Building
200 Park Avenue
New York, New York 10166
Telephone: (212) 801-9200
Facsimile: (212) 801-6400

RICHARD I. WERDER, JR.
HAROLD K. GORDON
TODD R. GEREMIA
JONES DAY
222 East 41st Street
New York, New York 10017
Telephone: (212) 326-3939
Facsimile: (212) 755-7306

Attorneys for Defendant-Appellant,
Clark E. McLeod

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

CASES

STATUTES

OTHER AUTHORITIES

Defendant-Appellant Clark E. McLeod respectfully submits this memorandum of law in support of his motion for a stay of a June 5, 2006 damages trial, pending appeal from a February 9, 2006 order of the Supreme Court, New York County (Lowe, J.), which granted plaintiffs' motion for partial summary judgment on their causes of action under Article 23-A of the New York General Business Law (the "Martin Act") and § 63(12) of the Executive Law.

INTRODUCTION

This is an action for securities fraud under the Martin Act and the Executive Law. In a forty-two page decision, the trial court granted summary judgment to plaintiffs-respondents, the State of New York and the New York Attorney General, on liability and then later ordered a June 5, 2006 trial on damages. (Order at 42)[1] Plaintiffs themselves have described the lower court's decision as "precedent-setting" in a press release announcing it. (Ex. D at 1) And, in an earlier press release, plaintiffs characterized this action as presenting "first-of-its-kind" theories of liability under the Martin Act and the Executive Law. (Ex. B at 1) The trial court's decision has also been noted as an "expansive interpretation" of pre-existing law by former SEC Commissioner Joseph Grundfest, who was quoted in an in-depth *Wall Street Journal* article about the "big change" brought about by, and the "broad[] ramifications" of, the new liability theories adopted by the trial court. (Ex. E)

McLeod has appealed from the trial court's order and will show, on multiple, independent grounds, that the order is indeed "unprecedented," *i.e.*, without any basis in law, and should be reversed. McLeod now seeks a stay of the lower court's damages trial pending appeal. Such a trial is, at best, premature before this Court has reviewed and ruled upon the myriad

---

[1] References to "(Order __)" are to the February 9, 2006 decision of the trial court, attached to McLeod's notice of motion. References to "(Ex. __)" are to the indicated exhibit to the Rubin Affirmation. References to "(Compl. ¶ __)" are to the Second Amended Complaint, attached as Exhibit A to the Rubin Affirmation. References to "(Rubin Aff. ¶__)" are to the referenced paragraph in the Rubin Affirmation.

issues of liability (and also damages)—many of them never before addressed by this or any other New York appellate court—presented by the trial court's unprecedented order. That order is also wrongly decided. As we describe in more detail below, the trial court ignored language in the Martin Act limiting its reach to conduct that is "engaged in to induce or promote" the purchase or sale of "securities." The Court also erroneously ruled that a court may impose liability under the Martin Act for an allegedly fraudulent failure to disclose in the absence of any pre-existing duty to disclose, improperly made findings at the summary judgment stage on many hotly contested issues of material fact, and never addressed McLeod's argument that there is no proof in support of plaintiffs' claim for damages.

We respectfully submit that, in all likelihood, this Court's review of the trial court's novel rulings will result in judgment for McLeod or material modifications to the trial court's order. A separate damages trial will then be a waste of time and effort, either because it will be unnecessary to determine damages or because any damages issues will have to be adjudicated again as part of a plenary trial. A stay pending appeal is well-warranted in these circumstances and should be granted. *See* 12 JACK B. WEINSTEIN, HAROLD L. KORN & ARTHUR R. MILLER, NEW YORK CIVIL PRACTICE ¶ 5519.13, at 55-168 (2d ed. 2005) (factors to be considered on a motion for a stay pending appeal "are the merits of the appeal, harm that might accrue to the appellant if the stay is denied, and potential prejudice to the respondent if the stay is granted").

The trial court refused to consider the merits of McLeod's request for a stay. (Ex. G at 5:3-6:3) The court denied McLeod's application, but not because a stay was inappropriate or the trial court disagreed with any of McLeod's arguments for why a damages trial should be deferred until after this Court resolves several antecedent liability issues. In fact, Justice Lowe stated that McLeod's application was "well taken," but said that he nevertheless felt constrained to adhere to his "consistent[]" position that he automatically denies nearly every request for a stay pending appeal and leaves it to this Court to consider and decide the merits of any stay application. (Ex. G at 5:3-6:3, "Your points are well taken. However, whenever there is a request for a stay [except where there is a case pending in another jurisdiction] my response to the request for a stay is this: When you file your notice of appeal, you will request of the Appellate Division that the Appellate Division issue a stay.").

This stay application is meritorious. McLeod should not be forced to defend against plaintiffs' asserted claim for millions of dollars in damages before this Court has resolved whether, and if so according to what legal standards, McLeod may be held liable on plaintiffs' "first-of-its-kind" theory of statutory "fraud" under the Martin Act and the Executive Law.

PERTINENT BACKGROUND

A. Overview of the Martin Act and Executive Law

"As New York's 'blue sky' law, the Martin Act governs the offer and sale of securities, commodities and other investment vehicles," including "the offer and sale of cooperative apartments ('coops') and condominium apartments." N.Y. Gen. Bus. Law Art. 23-A, PRACTICE COMMENTARIES: INTRODUCTION AND COMMENTARY OVERVIEW; *see also id.* PRACTICE COMMENTARY: SECURITIES, COMMODITIES AND OTHER INVESTMENTS ("Their name ['blue sky laws'] indicates the evil they were aimed at curtailing—speculative schemes grounded in nothing more than 'so many feet of blue sky.'"). "The Martin Act is thus a 'hybrid' statute governing two distinct . . . areas of the economy—the securities and real estate marketplaces." *Id.* This case concerns that part of the Martin Act that governs "the offer and sale of securities," not investments in real property.

Specifically, at issue here is the Martin Act provision that makes it unlawful to "engage[] in" any "fraud, deception, concealment, suppression, [or] false pretense" to "induce or promote the issuance, distribution, exchange, sale, negotiation or purchase within or from this state of any securities or commodities." N.Y. Gen. Bus. Law § 352-c(1). The elements of plaintiffs' claim under the Executive Law are, as plaintiffs concede, "virtually identical to those under the Martin Act." (Order at 28, quoting Pls.' Mem. of Law in Support of Motion for Summary J. at 28)

B. Plaintiffs' As-Pleaded Theories of Securities Fraud

This action was filed in September 2002 by the State of New York and the New York State Attorney General's Office against Clark McLeod, the founder and former CEO of an Iowa-based telecommunications company named McLeodUSA, Inc., and certain former CEOs of other telecommunications companies. (Ex. B at 1)

The complaint alleged that McLeod engaged in two types of securities fraud. First, plaintiffs' so-called "spinning" theory was that McLeod purchased what the complaint describes as "hot" shares in initial public offerings ("IPOs") through Salomon Smith Barney ("Salomon"), and, in exchange for Salomon's "allocating" these IPO shares for McLeod to purchase, McLeod allegedly directed McLeodUSA's investment banking business to Salomon. (Compl. ¶ 1) The second theory in plaintiffs' complaint was that McLeod directed McLeodUSA's investment banking business to Salomon as part of an alleged "arrangement" whereby Salomon's stock analysts would publish research reports that supposedly contained "biased" recommendations to buy McLeodUSA's stock—recommendations that, according to the complaint, the analysts did not believe were warranted by the facts. (Compl. ¶¶ 1, 55)

C. The Parties' Cross Motions For Summary Judgment

The parties engaged in extensive discovery, that included massive document productions from McLeod, McLeodUSA, and Salomon, and depositions of, among others, McLeod, McLeod's investment manager, officers of McLeodUSA, CEOs of other telecommunications companies, and employees of Salomon's investment banking and brokerage services arms. After the close of discovery, McLeod moved for summary judgment. (Rubin Aff. ¶ 14) McLeod argued that there was no proof to support the theories of securities fraud alleged in the complaint. (Rubin Aff. ¶ 14) Specifically, McLeod showed that there is no proof of any alleged "arrangement" whereby McLeodUSA "rewarded [Salomon] with banking work" and Salomon, in turn, issued "unduly optimistic research reports and buy recommendations" on McLeodUSA. (Compl. ¶¶ 6-7, Rubin Aff. ¶ 14) As McLeod pointed out, plaintiffs could not point to even a single Salomon analyst report on McLeodUSA that was unduly optimistic, nor did they have any proof that McLeod directed investment banking business to Salomon in exchange for unwarranted recommendations by Salomon on McLeodUSA stock. (Ex. C ¶¶ 24-28, 30-34)

On plaintiffs' "spinning" theory, McLeod showed that there was no evidence that McLeod rewarded Salomon with investment banking business in exchange for Salomon allowing McLeod to purchase IPO shares through his personal brokerage account. (Ex. C ¶¶ 46-48, 50-54) All of the alleged parties to this would-be scheme (McLeod and his investment manager, McLeodUSA's investment bankers at Salomon, and the separate Salomon professionals who administered McLeod's personal brokerage account) gave detailed, corroborated, and unrebutted testimony that McLeod did not receive any IPO allocations as a *quid pro quo* for directing investment banking business to Salomon. (Ex. C ¶¶ 47, 48, 50-54)

Plaintiffs cross-moved for summary judgment. (Rubin Aff. ¶ 16) In their motion, they abandoned their as-pleaded theories, and instead resorted to the unprecedented proposition that McLeod was liable for securities fraud solely because he (i) purchased IPO shares "while he was participating in the selection of SSB [Salomon] as McLeodUSA's investment bank"; and (ii) did not disclose to McLeodUSA's shareholders or its board of directors that he had made these purchases. (Rubin Aff. ¶ 16) According to plaintiffs, McLeod "was in an undisclosed conflict of interest" that "tended to deceive or mislead the public." (Rubin Aff. ¶ 16) Plaintiffs did not argue that they were entitled to summary judgment on their pleaded theories that McLeod directed investment banking business to Salomon in exchange for IPO allocations or "biased" coverage of McLeodUSA by Salomon's analysts. (Rubin Aff. ¶¶ 12, 16) Rather, on their revised view of this case, plaintiffs believed it was enough that McLeod purchased IPO shares through Salomon and did not disclose these purchases, regardless of whether McLeod actually engaged in any fraud in purchasing these securities.

D. The Trial Court's Order

In what plaintiffs themselves have described as a "precedent-setting decision," the trial court granted partial summary judgment to plaintiffs on their causes of action under the Martin Act and the Executive Law. (Order at 42, Ex. D at 1) The court noted at the outset that "the 'stock spinning scheme' *described in the complaint* was . . . a somewhat sophisticated form of bribery." (Order at 3, emphasis added) But the court went on to acknowledge that, in their summary judgment brief, plaintiffs' theory was that McLeod violated the Martin Act simply because he purchased IPO shares through Salomon and did not disclose these purchases to McLeodUSA's shareholders or its board of directors. (Order at 9, quoting plaintiffs' brief that "McLeod's actions in seeking and accepting hot IPOs from SSB and McLeodUSA's business partners while approving McLeodUSA's mandates to SSB placed McLeod in a position of conflict" that was "undisclosed")

The court made clear that it embraced plaintiffs' *revised* view of the case, *i.e.*, that McLeod could be liable under the Martin Act in the absence of any proof that he committed fraud in purchasing IPO shares. (Order at 10) On this theory, according to the court, "there are no factual issues" to try because "McLeod does not dispute either receiving and profiting from 'hot IPOs,' or that he made no disclosures to McLeodUSA's shareholders or board." (Order at 10) The trial court then announced a truly unprecedented rule that McLeod's IPO share purchases through Salomon were "per se" material to any investor in McLeodUSA and, therefore, should have been disclosed. (Order at 12)

The court did not identify any evidence, let alone undisputed evidence, to support its legal conclusion that a reasonable shareholder would have deemed McLeod's IPO purchases to have "actual significance," *i.e.*, to be "material" to, McLeodUSA's business. On this issue, McLeod submitted unrebutted evidence that he did not personally control McLeodUSA's decision to hire Salomon for investment banking services—McLeodUSA's Chief Financial Officer directed a careful, deliberative process for choosing the company's investment bankers. (Ex. C ¶¶ 10-15) The court decided to give this proof "no shrift" on the basis of an erroneous finding that McLeod was "McLeodUSA's majority shareholder." (Order at 13 n.12) In addition, McLeod showed that McLeodUSA shareholders had access to extensive, federally mandated public disclosures about Salomon's relationship with McLeodUSA, including disclosures of which McLeodUSA offerings Salomon underwrote and the fees that McLeodUSA paid Salomon for those services. (Rubin Aff. ¶¶ 31, 32) Without addressing this and other evidence on the materiality element of plaintiffs' claims, the court made an express "find[ing] that McLeod's non-disclosures are 'material' for Martin Act purposes" and that these "non-disclosures" "clearly tended to deceive or mislead the purchasing public" as to "the reasons underlying McLeod's decisions to have McLeodUSA retain [Salomon]." (Order at 13, internal punctuation omitted) On the basis of these findings, the trial court ruled that "the State is entitled to summary judgment on [its Martin Act] causes of action." (Order at 13)

The trial court relied heavily on *Monetta Financial Services, Inc. v. SEC*, 390 F.3d 952 (7th Cir. 2004). "[T]he court's research . . . uncovered" this case. (Order at 11) Plaintiffs did not rely it, and for good reason. *Monetta* did not deal with securities fraud under either federal or New York law. The case held that an *investment advisor* had violated the federal Investment

Advisors Act of 1940 by not disclosing to its mutual fund clients that the advisor had allocated shares in initial public offerings to certain of the mutual funds' directors. *See id.* at 955-56. McLeod is not and never was an investment advisor, and he is therefore not subject to the heightened disclosure duties imposed by the Investment Advisors Act and the Investment Company Act. *See* 15 U.S.C. § 80b-6(3); *see generally* 2 Tamar Frankel & Ann Taylor Schwing, *The Regulation Of Money Managers: Mutual Funds and Advisers* § 13.01[B], at 13-10.1 (2d ed. 2005) ("In contrast [to other federal securities statutes], *advisers have a duty to speak up to a greater extent* and not only to clients but also to prospective clients.") (emphasis added). Moreover, unlike the investment advisor in *Monetta*, McLeod did not allocate IPO shares to anybody and therefore did not do so "at the expense of ... [other] clients," as the investment advisor did in *Monetta*. Finally, the provision of the Investment Advisors Act at issue in *Monetta* does not—as the Martin Act does—require proof of fraud in connection with the purchase or sale of securities. The federal statute makes it unlawful for an investment advisor to "engage in any . . . course of business which operates as a fraud." 15 U.S.C. § 80b-6(2). Accordingly, the trial court's conclusion that "the non-disclosures at issue in *Monetta Financial Services* would also perforce constitute Martin Act violations" (Order at 12) is not supported by *Monetta*, the Investment Advisors Act, or the Martin Act.

The trial court's order concluded by granting plaintiffs partial summary judgment on all of their causes of action under the Martin Act and the Executive Law and ordering a "separate hearing" to determine "the amount of money damages due." (Order at 42) The court rejected McLeod's argument for dismissing plaintiffs' claim for restitution of McLeod's IPO gains—the only claim that could be at issue in the scheduled damages trial in light of the trial court's rulings in granting partial summary judgment to plaintiffs. (Order at 38-41) McLeod argued that plaintiffs were not entitled to this monetary remedy because there is no proof of what portion, if any, of McLeod's profits on the IPO shares he purchased through Salomon was attributable to the alleged "fraud," *i.e.*, McLeod's non-disclosure of the IPO share purchases. The trial court never addressed this argument. Instead, the court reasoned that a "hearing is necessary on the amount of restitution [McLeod] must pay," but did not specify what disputed issues of fact would be tried at that hearing. (Order at 39)

E. The Trial Court Refuses to Stay the Case and Schedules a Damages Trial

The day after McLeod filed his notice of appeal, he applied to the trial court for a stay of the damages trial pending appeal. (Ex. F) McLeod pointed out, among other things, that it would be premature and potentially wasteful to conduct a separate damages trial in this case while the Appellate Division is considering and resolving all of the underlying issues of liability that, as plaintiffs' own press release stated, have never been addressed before. (Exs. F, G at 1, Ex. Q 2:23-4:10, 3:5-10)

The trial court stated to McLeod's counsel, "Your points are well taken." (Ex. G at 5:10) But the court nevertheless denied McLeod's application on the ground that, for the sake of "consistency," the court denies stay requests "whenever" they are made (except where there are proceedings pending in another jurisdiction) and directs parties to make all of the same arguments in a motion for the Appellate Division to consider:

> I pride myself on consistency so that every lawyer who comes into this courtroom as opposed to any other knows what to expect of the Court. . . . [T]here is a consistency of procedure that is followed in this court.
>
> Your points are well taken. However, whenever there is a request for a stay outside of proceedings pending in another jurisdiction which may be rendering a decision that would directly affect my case here, my response to the request for a stay is this: When you file your notice of appeal, you will request of the Appellate Division that the Appellate Division issue a stay. I believe that you can make the same arguments that you made to me. . . .

> So what I will do is set a trial date. You will then file your notice of appeal, make your request, and you can tell them [the Appellate Division], as I suggest to every attorney, that the Court has indicated that the request for a stay should be presented to the Appellate Division.

(Ex. G at 5:3-6:3) The court thereafter set this case for a damages trial to begin on June 5, 2006.

ARGUMENT

McLeod respectfully requests that this Court stay the scheduled damages trial pending resolution of McLeod's appeal from the trial court's partial summary judgment order. A stay is well warranted here. McLeod's appeal has merit, he will be prejudiced by having to defend a trial on plaintiffs' multi-million dollar damages claim before this Court has established whether he may be held liable on plaintiffs' novel theory of securities fraud, and a stay will not prejudice plaintiffs in any cognizable way. *See, e.g.*, *Wilinson v. Sukiennik*, 120 A.D.2d 989, 989, 502 N.Y.S.2d 837, 837-38 (4th Dep't 1986) (ordering stay pending appeal where appellant "has demonstrated that his appeal . . . may have merit"); *see also* CPLR 5519, Practice Commentary C5519:4 ("presumptive merits of the appeal and any exigency or hardship confronting any party" are pertinent factors to consider on motion for a stay pending appeal); 12 WEINSTEIN, KORN & MILLER ¶ 5519.13, at 55-168.

I. THIS APPEAL PRESENTS SIGNIFICANT, NOVEL ISSUES OF LIABILITY THAT SHOULD BE RESOLVED BEFORE ANY TRIAL ON DAMAGES

It is illogical and a waste of the courts' and the parties' time and resources to conduct a piecemeal damages trial *before* this Court addresses and resolves the serious issues of liability that are raised by McLeod's appeal. Indeed, given the many novel liability issues presented by the trial court's order, this Court's decision will very likely have considerable impact on the trial court's liability determination—and therefore the very basis of the upcoming damages trial. If McLeod prevails on any one of the liability issues presented below, the trial court's order will be reversed and, at a bare minimum, McLeod will be entitled to a full trial on liability before any damages determination. The Court should stay this action and resolve these issues before McLeod is subjected to a cart-before-the-horse damages trial.

A. The Trial Court Ignored the Martin Act Requirement That Fraud Must Be "Engaged in to Induce or Promote" the Purchase or Sale of Securities

The trial court misapplied the Martin Act in ruling that plaintiffs are entitled to a liability judgment. Under the Martin Act provision at issue here, plaintiffs must establish that McLeod "engaged in" "fraud, deception, concealment, [or] suppression" to "induce or promote" the "distribution, exchange, sale, negotiation or purchase within or from this state *of any securities.*" N.Y. Gen. Bus. Law § 352-c(1) (emphasis added). As the Court of Appeals has repeatedly stated, "[t]he purpose of the [Martin Act] is to prevent all kinds of fraud *in connection with the sale of securities and commodities.*" *People v. Federated Radio Corp.*, 244 N.Y. 33, 38 (1926) (emphasis added); *see also People v. Lexington Sixty-First Assocs.*, 38 N.Y.2d 588, 595, 381 N.Y.S.2d 836, 840 (1976) (same). Plaintiffs have no proof that McLeod engaged in any fraud in connection with "the sale of securities." For this reason alone, the trial court's order should be reversed on appeal, and, if it is, no trial of any sort will be necessary.

As pleaded in their complaint, plaintiffs tried to satisfy the Martin Act's "induce or promote" requirement by alleging that McLeod directed investment banking business to Salomon in exchange for (i) Salomon issuing analyst reports that allegedly gave unwarranted, favorable coverage of McLeodUSA, purportedly to inflate the value of McLeodUSA securities; and (ii) allocating IPO shares to McLeod. (Compl. ¶ 1) Both prongs of this theory attempted to allege fraud "engaged in to induce or promote" the purchase and sale of "securities": "inducing or promoting" investors to purchase McLeodUSA securities, under the first prong; and "inducing or promoting" the sale of IPO shares to McLeod, under the second prong.

These allegations may have made for a nice press release when plaintiffs filed their complaint, but discovery showed that there is no ***proof*** to support either of plaintiffs' theories. Thus, the trial court could not grant plaintiffs summary judgment on the theories of liability pleaded in the complaint. Instead, the court relied on the radically different notion that McLeod's mere purchase of IPO shares through Salomon "placed McLeod in a position of conflict with his duties to the corporation" and that therefore, according to plaintiffs, McLeod should have *disclosed* these share purchases. (Order at 9) ***That is not a Martin Act violation***. Plaintiffs must show that McLeod "engaged in" a fraud to "induce or promote" the "distribution, exchange, sale, negotiation or purchase . . . *of any securities*." N.Y. Gen. Bus. Law § 352-c(1) (emphasis added). But there is no proof that McLeod engaged in any "fraud" "to induce or promote" the purchase of IPO shares. (Rubin Aff. ¶ 25) Those purchases were not fraudulent or unlawful in any way. On this ground alone, plaintiffs are not entitled to summary judgment on their Martin Act claims—McLeod is—and the trial court's order should therefore be reversed.

The trial court accused McLeod of "ignor[ing] language set forth in GBL §§ 352(1) and 352-c(2)." (Order at 22) The court described these statutes as catch-all provisions making it "a violation of the Martin Act to 'engage in any artifice, agreement, device or scheme to obtain money, profit, or property by' fraudulent means." (Order at 22) Neither of these provisions operates to expand the reach of the Martin Act beyond fraudulent conduct engaged in to induce or promote the sale of securities, as the trial court erroneously held.

Section 352(1) does not even give rise to a cause of action, and it is not at issue in this case. That provision, titled "Investigation by attorney-general," merely gives the Attorney General authority to "require or permit [a] person" to "file with [the Attorney General] a statement in writing under oath" as part of an investigation by the Attorney General. N.Y. Gen. Bus. Law § 352(1). The other provision cited by the trial court, Section 352-c(2), is not a blanket prohibition against engaging in any and all types of "fraudulent means," as the trial court erroneously paraphrased the statute. (Order at 22) The trial court inexplicably chopped off the last—and, for purposes of this issue, the most important—part of Section 352(2). That last phrase states that it is unlawful to engage in any "artifice, agreement, device or scheme to obtain money, profit or property *by any of the means prohibited by this section.*" N.Y. Gen. Bus. Law § 352-c(2) (emphasis added). With one exception, all of the "means prohibited by" Section 352-c require fraud "engaged in to induce or promote the issuance distribution, exchange, sale, negotiation or purchase" of "*any securities or commodities.*" *See id.* § 352-c(1), (5), (6) (emphasis added). The only exception is Section 352-c(3), which makes it unlawful to represent that an entity is an "exchange" or a "contract market" unless registered as such with the SEC or the Commodities Futures Trading Commission. That provision is plainly not applicable here.

In sum, the Martin Act does not allow plaintiffs to establish liability under their novel "conflict of interest" theory. The trial court lost sight of the statute's requirement to establish a fraud "engaged in to induce or promote" the purchase or sale of "securities," and, more importantly, plaintiffs failed to submit any proof to satisfy this requirement. For this reason alone, McLeod's appeal from the trial court's order raises, at a minimum, a serious legal issue that warrants a stay of all further proceedings pending review by this Court.

B. Federal Law Preempts Plaintiffs' Claims

Even assuming that the Martin Act's "induce or promote" requirement does not limit its reach, federal law would preempt plaintiffs' claims.

The National Securities Market Improvement Act of 1996 ("National Act") prohibits any state from imposing disclosure requirements on an issuer whose stock is—as McLeodUSA's was at all relevant times—quoted on NASDAQ. *See* 15 U.S.C. § 77r(a)(2)(B) ("[N]o law, rule, regulation, or order, or other administrative action of any State or any political subdivision thereof—shall directly or indirectly prohibit, limit, or impose any conditions upon the use of—any proxy statement, report to shareholders, or other disclosure document relating to a covered security or the issuer thereof . . . ."); *see also Zuri-Invest AG v. NatWest Fin. Inc.*, 177 F. Supp. 2d 189, 192 (S.D.N.Y. 2001) (National Act "precludes states from imposing disclosure requirements on prospectuses, traditional offering documents and sales literature relating to covered securities").

Federal law does not require an issuer or an officer of an issuer to disclose IPO share purchases, and, by virtue of the National Act, New York may not do so either. The trial court ruled that plaintiffs' claims are nevertheless preserved by the National Act's "savings clause," which preserves the States' jurisdiction to "bring enforcement actions with respect to fraud or deceit . . . in connection with securities or securities transactions." 15 U.S.C. § 77r(c)(1) (emphasis added). As noted above, however, plaintiffs' claims are not predicated on "fraud or deceit . . . *in connection with securities or securities transactions*." *Id.* (emphasis added). Instead, plaintiffs' claims are predicated on McLeod's failure to *disclose* his IPO share purchases, without any evidence that McLeod engaged in "fraud or deceit in connection with" those purchases, but solely because they purportedly gave rise to an abstract "conflict of interest" that plaintiffs think McLeod should have disclosed to McLeodUSA shareholders. (Ex. H at 22-24) This is a naked attempt to impose a brand new disclosure obligation on McLeod (and all CEOs and former CEOs of public companies), which is not preserved by the National Act's savings clause. *Cf. Guice v. Charles Schwab & Co.*, 89 N.Y.2d 31, 38-39, 651 N.Y.S.2d 352, 355 (1996) (Martin Act claim implicitly preempted by federal securities law).

The trial court's order thus presents an important issue of federal law for the Court to review, assuming, as the trial court erroneously ruled, that the Martin Act's "induce or promote" requirement does not foreclose plaintiffs' claims. For this reason, too, a stay is warranted here.

C. McLeod Had No Duty to Make the Disclosures That Plaintiffs Say He Should Have Made

The trial court also ignored the requirement that, for plaintiffs' fraud-by-omission claim to be actionable under the Martin Act, they must show that McLeod had a duty to disclose the facts at issue. (Rubin Aff. ¶ 28)

The trial court stated that McLeod relied on only a single Second Department case, *Dash v. Jennings*, 272 A.D. 1073, 1074, 74 N.Y.S.2d 881, 883 (2d Dep't 1947), as support for this requirement.[2] In fact, McLeod relied on, among other cases, the Court of Appeals' landmark Martin Act decision in *People v. Federated Radio Corp.*, 244 N.Y. 33 (1926). The trial court cited *Federated* elsewhere in its decision, but curiously made no mention of it in connection with its discussion of the duty element of a Martin Act claim. (Order at 13 n.12)

Federated involved an omission in a prospectus, and the Court specifically addressed the duty element of a Martin Act claim for fraud-by-omission. In resolving whether "the complaint states facts to constitute a cause of action" against the stock's promoters, the Court of Appeals ruled that "[p]romoters are under a duty to make reasonable investigation before issuing a prospectus" and that they could not "exempt themselves from [this] duty" by a disclaimer in the prospectus that the information in it might not be reliable. *Id.* at 37, 41. In cases since *Federated* where duty to disclose has been put in issue, courts have consistently found it necessary to address whether a defendant was under a *duty* to make a disclosure before imposing liability under the Martin Act for non-disclosure. *See, e.g., People v. Royal Secs. Corp.*, 5 Misc. 2d 907, 910-11, 165 N.Y.S.2d 945, 950-51 (Sup. Ct. N.Y. Cty. 1955) (promoter could be held

[2] The trial court attempted to distinguish *Dash* on the ground that "the appellate court was reviewing a common law fraud claim therein, and not a Martin Act claim." (Order at 20) That is not correct. After noting that "concealment is not fraudulent unless there is a duty to speak" and that the plaintiff had failed to plead a duty to disclose on the facts of that case, the Second Department expressly held that "[t]he amended complaint should omit all references to the Martin Act." 272 A.D. at 1074, 74 N.Y.S.2d at 883.

liable for non-disclosure because it "was under an absolute duty to confirm the transactions"); *People v. Photocolor Corp.*, 156 Misc. 47, 53, 281 N.Y.S. 130, 137 (Sup. Ct. N.Y. Cty. 1935) ("Promoters are under a duty to make reasonable investigation.").

In this case, McLeod had no pre-existing duty to disclose his IPO share purchases to McLeodUSA's shareholders or its board of directors. As McLeod pointed out in his summary judgment papers—and plaintiffs did not contest this—there is no state or federal statute or regulation, no rule promulgated by any self-regulatory organization overseeing the securities industry, and (before the trial court's order) no decisional law that required an officer or director to disclose to his company whether he has purchased IPO shares and, if so, how or from whom. The disclosure obligation that the trial court imposed was entirely new—"unprecedented" to paraphrase plaintiffs' own press release.

The trial court cited a provision of New York's Business Corporation Law and a handful of decisions under New York law that recite the general proposition that a director of a corporation owes a fiduciary duty to the corporation's shareholders.[3] (Order at 21-22) But none of these authorities addressed whether or in what circumstances a director is duty-bound to disclose to shareholders that he purchased IPO shares. (Rubin Aff. ¶ 28) So the trial court was essentially crafting an entirely new duty of disclosure. Whether it might be a good idea to impose such a duty may be a debatable question, but liability cannot be imposed under the Martin Act unless McLeod was under a *pre-existing* duty to disclose his IPO share purchases.

---

[3] The trial court expressly declined to rely on the Delaware Court of Chancery's decision in *In re eBay, Inc. Shareholders Litig.*, No. 19988-NC, 2004 Del. Ch. LEXIS 4 (Del. Ch. Jan. 23, 2004). (Order at 11) *eBay* was not a securities fraud case. It was a derivative action brought on behalf of eBay that alleged usurpation of a corporate opportunity under Delaware law. Moreover, the *eBay* decision adjudicated a motion to dismiss, and therefore assumed as true allegations that eBay insiders accepted "bribe[s]" of IPO allocations in exchange for directing investment banking business to Goldman Sachs. 2004 Del. Ch. LEXIS 4 at *2, *4. As noted above, plaintiffs abandoned that theory in this case after discovery uncovered no proof of it.

In sum, the duty imposed on McLeod by the trial court has never before been recognized by any court, in any regulation, or in any statute—indeed, prior to the trial court's opinion, no practitioner of securities law could have cited to any legal authority that required McLeod to make the disclosures at issue in this case. (Ex. E, Rubin Aff. ¶ 28) A stay is warranted pending appellate review of whether the trial court may, by retroactive application of its own decision, impose this unprecedented disclosure obligation on McLeod.

D. At a Minimum, There Are Myriad Disputed Issues of Fact on Whether Disclosure of McLeod's IPO Share Purchases Was "Material"

This case should also be stayed pending appeal because the trial court's ruling that McLeod's non-disclosure of his IPO share purchases through Salomon was, as a matter of law, a material, fraudulent omission is also in error.

A fact is not deemed material for Martin Act purposes unless there is a "substantial likelihood" that an "actual shareholder" would have deemed it to have "actual significance" in light of the "'total mix' of information available." *State v. Rachmani Corp.*, 71 N.Y.2d 718, 726-27, 530 N.Y.S.2d 58, 62-63 (1988) (internal quotation marks omitted). The trial court resolved significant issues of material fact, without first acknowledging them, and expressly "found" that McLeod's purchases of IPO shares through Salomon were "material" to McLeodUSA shareholders. (Order at 13) At best for plaintiffs, there are hotly disputed questions of fact on this issue.[4]

Indeed, there is no actual evidence to support the trial court's conclusory "finding" that there is a "substantial likelihood" that any reasonable investor in McLeodUSA would have deemed McLeod's purchase of IPO shares to have "actual significance" in the circumstances

[4] McLeod argued to the trial court that the evidence shows that no reasonable shareholder would have considered McLeod's non-disclosure of IPO share purchases through Salomon to be material, for many of the reasons set forth here. (Rubin Aff. ¶¶ 30-33) At best for plaintiffs, the record shows that materiality is an issue to be determined at a full trial.

here. (Order at 12-13) McLeod purchased IPO shares through Salomon at the established offering price, through his own investment account, and with his own money. (Ex. C ¶¶ 35-40) Also, contrary to plaintiffs' allegation that McLeod reaped quick profits by selling his IPO shares "within days or weeks" of purchase (Compl. ¶ 26), McLeod held his IPO shares for an average of more than a year and then ultimately sold them at prevailing market prices. (Ex. H at SBT2A 036231.32)

The trial court's finding that McLeod had a "remunerative relationship" with Salomon, and thus that McLeod's non-disclosure of share purchases he made through Salomon was "per se" material to McLeodUSA shareholders, has no basis in fact. ***McLeod bore the risk of owning the securities that he purchased through Salomon.*** Importantly, although McLeod profited overall on the IPO shares he purchased through Salomon, he did not have any guarantee on his investment, as the trial court's unbridled rhetoric suggests. (Order at 2, characterizing McLeod's IPO share purchases as "vast, illicit compensation") Indeed, the trial court's tidy analysis ignored that McLeod *lost* more money in 2001 on the IPO shares he purchased through Salmon than he gained in the years 1997 and 1998 *combined.* (Ex. H at SBT2A 036231.27-33) Moreover, while the trial court several times intoned that McLeod purchased IPO shares through Salomon "on 32" or, incorrectly, "34 occasions" (Order at 3-4, 9), the court never once mentioned that McLeod *lost money* on fifteen of the companies (*i.e.*, nearly half) whose IPOs he invested in. (Ex. H at SBT2A 036231.27-33) These were not "nearly risk-free" investments, as the complaint alleges. (Compl. ¶ 1) There is at least an issue of fact as to whether, in these circumstances, an "actual shareholder" would have deemed McLeod's IPO share purchases to be in any way "material" to McLeodUSA's investment banking relationship with Salomon.[5]

---

[5] The trial court's finding that a shareholder would "infer that [McLeod] ha[d] abandoned or at least compromised his position of trust" because McLeod purportedly "enter[ed] into a remunerative relationship with

The trial court swept aside other disputed issues of fact as well. The court never addressed the "total mix" of information available to McLeodUSA shareholders concerning McLeodUSA's relationship with Salomon. (Rubin Aff. ¶ 31) As part of its federally mandated disclosures, McLeodUSA disclosed that Salomon performed investment banking services for it as well as the fees that the company paid to Salomon. (Ex. C ¶¶ 22, 49) Salomon's analyst reports on McLeodUSA also disclosed that Salomon had an investment banking relationship with McLeodUSA. *See* NASD Rule IM-2210-1(6)(A); Ex. C ¶ 23. And, as a condition to *every* securities offering McLeodUSA made with Salomon as the underwriter, the NASD made an official determination that Salomon's fees were fair and reasonable. *See* NASD Rule 2710. All of this was in the "total mix" of information available to any "actual shareholder" of McLeodUSA. The trial court should not have just ignored this evidence. And, taken into proper consideration, it shows that there is at least a disputed issue of fact as to whether McLeod's IPO share purchases would have had "actual significance" to a McLeodUSA shareholder.

In sum, the trial court's finding that "McLeod's non-disclosures are 'material' for Martin Act purposes" (Order at 13) is not likely to survive an appeal. It will then either be unnecessary for a damages determination or the scheduled damages trial will have to be conducted again. To avoid this unfair and inefficient result, the Court should order a stay pending appeal.

(continued...)

[McLeodUSA's] clients" is also unsupported by the evidence. (Order at 12) This theory was not even alleged to be "spinning." In all events, McLeod did not enter into any sort of "remunerative relationship" with the issuers of telecommunications companies in which he owned stock, as the trial court improperly found. In fact, McLeod lost a total of more than $1.7 million on three of these investments. (Ex. H at SBT2A 036231.27-33) There is also extensive, *uncontradicted* evidence that the CEOs who arranged for IPO shares to be allocated to McLeod did so because McLeod was a well-regarded leader in the telecommunications industry and, as such, was valued as a "trophy" investor whose participation in an IPO was deemed a valuable "a vote of confidence" as the issuer prepared to make its first public offering of securities.

E. Plaintiffs' Cause of Action Under the Executive Law Rises or Falls With Their Causes of Action Under the Martin Act

For all of the reasons stated above, summary judgment for plaintiffs on their cause of action under the Executive Law is also likely to be reversed or modified on appeal. As the trial court acknowledged and plaintiffs concede, for purposes of this case "'the elements of a claim under § 63(12) [of the Executive Law] are virtually identical to those under the Martin Act ....'" (Order at 28, quoting plaintiffs' brief at 28)

II. THIS COURT WILL ADDRESS SIGNIFICANT ISSUES OF DAMAGES IF IT UPHOLDS THE TRIAL COURT'S LIABILITY JUDGMENT

Even if the Court were to uphold the trial court on all of the liability issues on appeal, there is a serious question as to whether plaintiffs are entitled to any money judgment against McLeod. The Court's disposition of this issue may either make a damages trial unnecessary or, at a minimum, will properly frame the issues to be tried in such a proceeding.

The Martin Act provides that the Attorney General may make "an application to direct restitution of any moneys or property obtained directly or indirectly by any . . . fraudulent practice [as defined in the Martin Act]." N.Y. Gen. Bus. Law § 353(3). Pursuant to this provision, plaintiffs included a claim for restitution in their complaint. (Compl. ¶ 102) Under the trial court's order, that claim is to be adjudicated in the upcoming damages trial.

McLeod moved for summary judgment on plaintiffs' restitution claim on the ground that that there is no proof of what, if any, "moneys or property" McLeod gained or McLeodUSA shareholders were deprived of due to McLeod's failure to disclose his IPO share purchases. (Rubin Aff. ¶ 36) Plaintiffs are clearly not entitled to *all* of McLeod's profits on the sale of his IPO shares. On plaintiffs' revised view of the case—and the theory on which they were granted partial summary judgment—it is McLeod's *non-disclosure* of these purchases, not the purchases *themselves*, that plaintiffs say is the alleged "fraud."

The trial court agreed with McLeod that the Attorney General bears the burden to prove what portion, if any, of the claimed restitution may be "ascribed to the defendant's fraud." (Order at 39, citing *People ex rel. Vacco v. Appel*, 258 A.D.2d 957, 958, 685 N.Y.S.2d 504, 505 (4th Dep't 1999)). But the court never addressed McLeod's argument that plaintiffs' restitution claim should be dismissed precisely because plaintiffs had not come forward with actual proof to show that *any* portion of McLeod's IPO gains are attributable to "non-disclosure" of his IPO share purchases. The court instead ruled "that a hearing is necessary on the amount of restitution that [McLeod] must pay," without identifying any disputed issues of fact—and there are none—to be tried on this claim. (Order at 39)

Under well-established principles, McLeod was entitled to a judgment on plaintiffs' restitution claim. If the Court agrees with McLeod on the proper application of this basic rule of civil procedure, there will be no need to conduct the scheduled trial to determine whether plaintiffs are entitled to any restitution. *See, e.g.*, *Daly v. Messina*, 267 A.D.2d 345, 345, 699 N.Y.S.2d 921, 921 (2d Dep't 1999) (dismissing claim for damages due to alleged fraud where, "[a]fter the respondents made out a *prima facie* case for summary judgment, in opposition to the motion, the plaintiff failed to submit proof of damages").

III. PLAINTIFFS WILL NOT BE PREJUDICED BY A STAY

A stay pending appeal will conserve the time and resources of the parties—and the trial court's time and resources as well—by avoiding a trial on damages that is not likely to produce a sustainable judgment. Rather, calculation of damages should await this Court's answer to the many serious issues of liability and damages underlying Justice Lowe's unprecedented ruling.

Plaintiffs cannot credibly contend that there is any need to rush to judgment here. Indeed, after oral argument on the cross motions for summary judgment, counsel for plaintiffs asked the trial court to defer a trial until after the court rendered its decision because plaintiffs wanted to know whether certain issues remained in the case before preparing for trial. The same rationale applies now, with even more force: the trial court and the parties should know what liability and damages issues, if any, will remain in this case and what legal standards will govern plaintiffs' claims *before* any trial is conducted.

In these circumstances, plaintiffs cannot show any prejudice if a stay were granted. On the other hand, the prejudice to McLeod in the absence of a stay is considerable. McLeod faces the prospect of investing the time and money to try a multi-day damages cases now (which will require fact and expert witnesses, pre-trial motions, and then post-trial submissions), having the result of that trial vacated by a superseding decision from this Court, and then possibly re-trying the case on liability and damages. McLeod should not be subjected to the threat of a multi-million dollar judgment until this Court determines whether plaintiffs may lawfully assert their novel causes of action and, if so, whether they are entitled to the considerable sums they are seeking as restitution. To avoid this unfair result, the Court should stay all proceedings in this case pending disposition of the appeal.

CONCLUSION

McLeod therefore respectfully requests that the Court enter an order staying all proceedings in the trial court until this Court has ruled upon McLeod's appeal from the trial court's liability order.

Dated: March 31, 2006

GREENBERG TRAURIG, LLP
Met Life Building
200 Park Avenue
New York, New York
Telephone: (212) 801-9200
Facsimile: (212) 801-6400

By: Israel Rubin
Israel Rubin

JONES DAY
Richard I. Werder, Jr.
Harold K. Gordon
Todd R. Geremia
222 East 41st Street
New York, New York 10017
Telephone: (212) 326-3939
Facsimile: (212) 755-7306

Attorneys for Defendant-Appellant,
Clark E. McLeod

AFFIRMATION OF SERVICE

I, Todd R. Geremia, an attorney admitted to practice in the State of New York and not a party to this action, hereby affirm under penalties of perjury that the foregoing Appellant's Memorandum of Law in Support of His Motion for a Stay Pending Appeal was served on counsel for the parties in this action by delivering a copy of it by overnight mail on March 31, 2006 to the following:

Mariya S. Treisman, Esq.
Assistant Solicitor General
State of New York, Office of the Attorney General
Division of Appeals and Opinions
120 Broadway—25th Floor
New York, New York 10271

Andrew J. Lorin, Esq.
State of New York, Office of the Attorney General
120 Broadway
New York, New York 10271

Attorney for Plaintiffs,
State of New York and Eliot Spitzer

Dated: March 31, 2006

Todd R. Geremia