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PRACTICE PERSPECTIVES:
SECURITIES AND SHAREHOLDER LITIGATION & SEC ENFORCEMENT

Cutting-Edge Issues in Securities Litigation

letter from the practice chairs

Welcome to the Securities and Shareholder Litigation & SEC Enforcement issue of *Practice Perspectives*. The past few years have seen some dramatic changes in the United States capital markets, and those changes have affected and will continue to affect the areas of private securities litigation and SEC enforcement. This issue of *Practice Perspectives* is authored by lawyers in the Firm's Securities and Shareholder Litigation & SEC Enforcement Practice. In this issue, we highlight recent decisions and some litigation and enforcement trends that are likely to affect our clients. Lawyers in our practice not only litigate and advise on these issues regularly, but also seek to educate our clients through presentations and the Practice Newsletter on developments in this fast-paced area of the law as they occur.

In this issue of *Practice Perspectives*, we examine how Congress's efforts to reform securities-fraud class-action litigation—through passage of the Private Securities Litigation Reform Act of 1995—have raised difficult questions that have divided federal courts. In particular, we discuss the evolving standards for pleading *scienter* in a securities-fraud class action. Another article analyzes the changes to the law of pleading and demonstrating loss causation in the aftermath of the Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo*. This article examines the long-term implications of the decision and discusses new arguments and defensive strategies now available for companies defending securities-fraud cases.

This issue also identifies an emerging area of litigation involving investments in highly structured investment products known as "collateralized debt obligations" ("CDOs"). While largely unknown 10 years ago, CDOs today attract billions of dollars of investment capital from investors of every stripe. Finally, in the area of SEC enforcement, we address the effect of the "McNulty Memo" on corporate cooperation in government investigations.

We hope you will find the articles both interesting and helpful, and we welcome any comments, questions, or thoughts you would like to share with us. We also welcome you to sign up for the periodic Practice Newsletter, which you can choose to receive either electronically or in hard copy. Finally, please feel free to contact us with any requests for topics you would like to see us address in the future. ■

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Peter J. Romatowski
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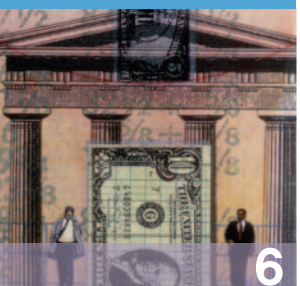

JONES DAY'S SECURITIES AND SHAREHOLDER & SEC

Jones Day's Securities and Shareholder Litigation & SEC Enforcement Practice consists of approximately 75 attorneys who counsel and represent companies and their directors and officers in regard to the risks in today's volatile environment posed by securities-fraud class actions, shareholder derivative actions, and federal and state regulatory investigations.

Driven by our clients' business objectives, the members of the practice draw upon Jones Day's global presence and resources to develop and implement strategic litigation plans tailored to the specific demands of each situation.

We have a core group of lawyers who spend the majority of their time defending companies and individuals who have been sued on allegations that their corporations have made false and misleading statements in violation of the Securities Act of 1933, the Securities Exchange Act of 1934, and other federal securities and/or state fraud laws. Our lawyers have experience in all aspects of these cases as they are litigated under the Private Securities Litigation Reform Act of 1995 and against all of the major plaintiffs' law firms. Our approach is to be aggressive and win, not settle, these cases, and we have done so in motions to dismiss, class certification challenges, Daubert contests, and motions for summary judgment. Many of these cases are predicated upon accounting issues, and we bring attorneys who have worked with a company's accounting officers, auditors, and experts on several cases over a number of years. These attorneys have a grasp of accounting issues that is distinctive. Jones Day's attorneys also have broad experience in the issues raised by shareholder derivative actions and serve as lead counsel in several matters involving securities-fraud claims, shareholder derivative actions, and governmental investigations. Our coordinated team approach allows

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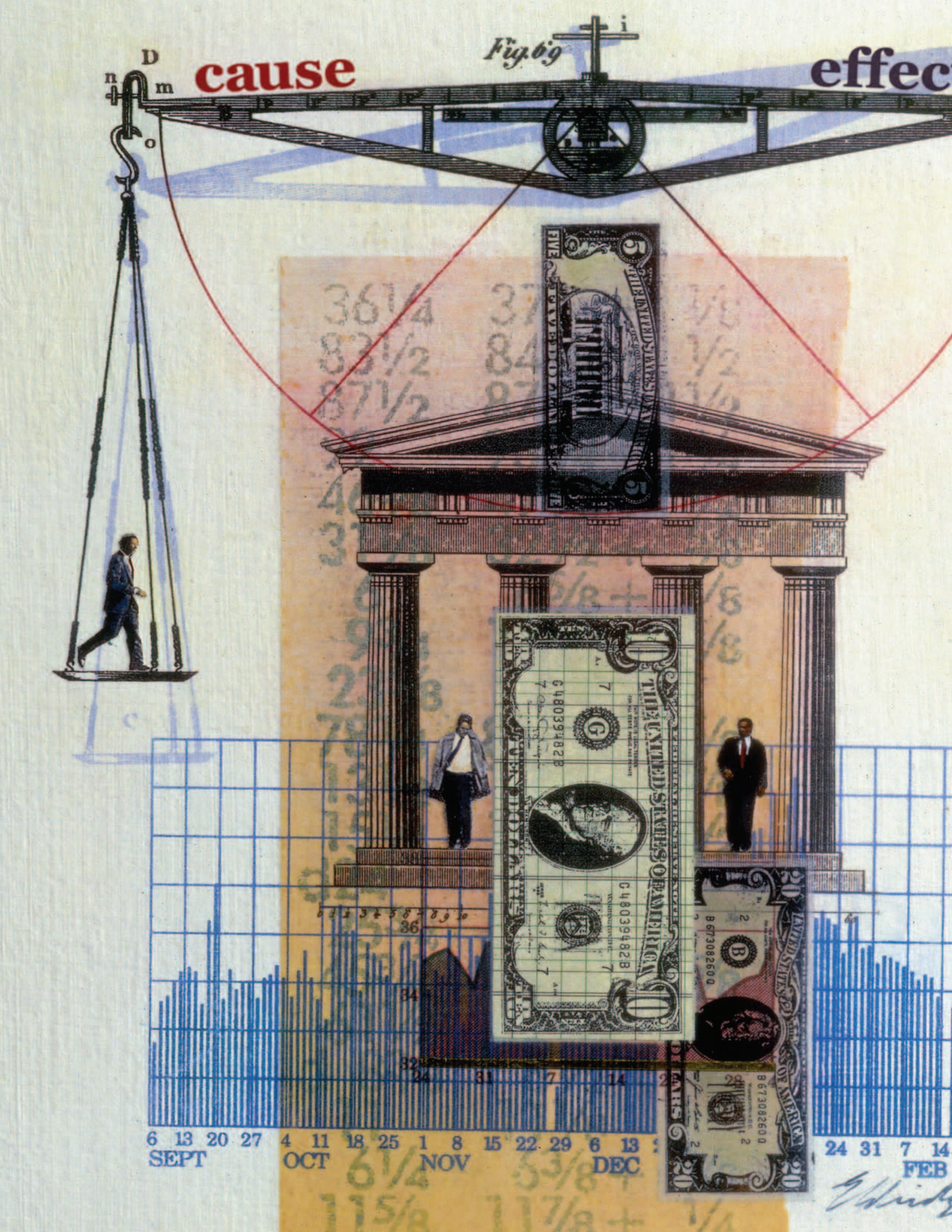
LITIGATION
ENFORCEMENT PRACTICE

us to manage all of the disparate risks that each of these claims poses, guided by a single strategic objective—to win. We are also well versed in corporate governance concepts, and we frequently counsel clients on issues related to director indemnification and directors' and officers' liability insurance.

Jones Day's Securities Enforcement lawyers bring to each engagement extensive experience in investigating, prosecuting, defending, and trying the most sophisticated administrative, civil, and criminal securities and commodities enforcement matters. Our partners have served at the SEC and as chief of the Securities and Commodities Fraud Unit in the U.S. Attorney's Office for the Southern District of New York. They represent clients before the Securities and Exchange Commission, the Commodity Futures Trading Commission, the industry self-regulatory organizations, and state securities commissioners, as well as various U.S. Attorneys' Offices and other units of the Justice Department. Our lawyers have tried federal securities-law charges before criminal juries, district judges, and administrative law judges. They routinely advise and conduct internal investigations for public companies, boards of directors and various board committees, and management. They have also served upon recommendation of the SEC and by appointment of the court as consultants and to oversee settlements in SEC actions. ■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By Meir Feder, Thomas R. Jackson, and Joshua S. Roseman

CAUSE AND EFFECT:

Section 10b-5 Not a Loss Insurance Policy

The price of Company XYZ's stock falls precipitously following an announcement of unexpected "bad" news. Within days, 10b-5 lawsuits are filed, claiming that the "bad" news was the result of fraud—that some member of management either knew, or should have known, of the "bad" news well before that news was revealed to the market. Damages for the entire value of the market decline over an extended period of time are sought. Sound familiar?

This scenario repeats itself almost daily, but since the *Dura Pharmaceuticals, Inc. v. Broudo* decision (544 U.S. 336 (2005)) in April of 2005, there's a slight twist: The plaintiff must now plead, and ultimately prove, a causal connection between the alleged fraud and the claimed loss. *Dura*'s full impact remains to be developed, but the natural implications favor defendants at the motion-to-dismiss and summary-judgment phases as well as in expert damage calculations.

At a minimum, *Dura* forces a critical focus on the true causes of any decrease in stock value and requires the removal from that analysis of any other causes for the stock's decline, resulting in lower damage claims than would otherwise have prevailed. That process also demands greater precision and effort from plaintiffs' experts if they are to survive *Daubert* motions. *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993).

THE DECISION IN *DURA*

The plaintiffs purchased stock in Dura Pharmaceuticals, Inc., between April 15, 1997, and February 24, 1998. Several fraudulent misstatement claims were asserted in the district court. The claim that survived to the Supreme Court focused on allegedly false statements made by Dura relating to a new asthmatic-spray device that was undergoing FDA approval. Plaintiffs alleged that "Dura falsely claimed that it expected the FDA would soon grant its approval." 544 U.S. at 339. On February 24, 1998, Dura announced lower-than-expected earnings, and the next day its stock price fell by almost half. Approximately eight months later, in November 1998, Dura announced that the FDA would not approve the asthmatic-spray device.

Confronted with the FDA decision occurring eight months after the end of the class period, the district court found loss causation to be lacking. How could the truth about FDA approval reaching the market eight months after the close of the class period cause any damage? The Ninth Circuit, however, disagreed. According to that court, the injury occurred "on the date of purchase," 393 F.3d at 938, as a result of the simple fact that the plaintiffs had paid a price allegedly inflated by fraud. The Supreme Court reversed.

Speaking for a unanimous Court, Justice Breyer noted that the 10b-5 claim "resembles, but is not identical to, common-law tort actions for deceit and misrepresentation." 544 U.S. at 341. From that premise, the Court concluded that the Ninth Circuit's "statement of the law [was] wrong. Normally, in cases such as this one (*i.e.,* fraud-on-the-market cases), an inflated purchase price will not itself constitute or proximately cause the relevant economic loss." 544 U.S. at 342. As the Supreme Court saw the issue, there could be no injury at the time of purchase, since the allegedly inflated purchase price was fully offset by the allegedly inflated value of the stock purchased. Any purchaser of the allegedly inflated stock that sold the stock prior to the fraud becoming public and incorporated in the stock price would suffer no damages from either the purchase or the sale of the stock.

The Court's concern was making sure that 10b-5 causes of action did not become insurance policies for any market loss that might be suffered:

> The securities statutes seek to maintain public confidence in the marketplace. They do so by deterring fraud, in part, through the availability of private securities fraud actions. But the statutes make these later actions available, not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause.

544 U.S. at 345. *Dura*'s message is clear—plaintiffs must connect their theory of liability with their theory of damages.

IMPLICATIONS FOR THE FUTURE

Dura's loss-causation analysis creates new opportunities for companies defending securities-fraud cases. In particular, *Dura* has at least two key implications. First, a plaintiff in most cases must plead and prove that the truth allegedly falsified by the defendant became known before the drop in stock price from which the plaintiff claims to have suffered a loss. Second, a plaintiff who claims that the disclosure of the truth caused his losses must also identify the new information conveyed by the disclosure and tie that disclosed information to the movement of the stock price. What is less clear, however, is the minimum a plaintiff must allege to satisfy this burden at the pleading stage.

Dura involved a fact pattern that made it relatively easy for the Court to conclude that the plaintiff had not adequately pleaded loss causation—there was a total absence of allegations linking any investment losses to any disclosures. Accordingly, post-*Dura*, courts have had no problem dismissing complaints that, like the *Dura* complaint, fail to "provid[e] the defendants with notice of what the relevant economic loss might be or what the causal connection might be between the loss and the misrepresentation." *See, e.g., D.E. & J. Ltd P'ship*, 133 Fed. Appx. 994, 999–1000 (6th Cir. 2005) (pleadings are inadequate if they fail to "plead that the alleged fraud became known to the market on any particular day," "estimate the damages that the alleged fraud caused," and "connect the alleged fraud with the ultimate disclosures and loss"); *Tricontinental Industries, Ltd. v. PricewaterhouseCoopers, LLP*, No. 05-4322, 2007 WL 102985, at *15-*16 (7th Cir. Jan. 17, 2007) (loss-causation allegations must show that loss occurred after alleged material misrepresentation "became generally known").

Likewise, post-*Dura*, courts have routinely found that plaintiffs cannot adequately plead loss causation if they sell all of their shares *before* the market learns the allegedly true but misrepresented facts. *See, e.g., Collier v. Aksys Ltd.*, No. 4CV1232 (MRK), 2005 WL 1949868, at *13 (D. Conn. Aug. 15, 2005); *In re: Sawtek, Inc. Sec. Litig.*, No. 603CV294ORL31DAB, 2005 WL 2465041, at *12 (M.D. Fl. Oct. 6, 2005).

The more difficult question at the pleading stage is determining what types of alleged disclosures will suffice as "revelation of the truth" to the market. The most clear-cut "revelation of the truth" is a formal corrective disclosure made by a company. But in the absence of a formal corrective disclosure, post-*Dura* litigants can expect battles at the motion-to-dismiss stage surrounding whether a particular set of facts is sufficient to establish that the "truth" in any event became known to the market.

Dura will likely be an even more substantial weapon for defendants at later stages of the case, if a plaintiff is fortunate enough to survive a motion to dismiss. *Dura* makes clear that such a plaintiff still has to *prove* that the defendant's misstatement or omission caused the plaintiff's loss. Thus, to survive a summary-judgment motion, a plaintiff normally must present evidence from which a jury could determine "when or how the fraudulent statements came to light" and "what particular drop in price can be attributed to the revelation." *Ray v. Citigroup Global Markets, Inc.*, No. 03 C 3157, 2005 WL 2659102, at *4 (N.D. Ill. Oct. 18, 2005). Without such evidence, no jury could reasonably find that a decline in stock price was proximately caused by disclosure of the misstatement or omission. *Id.*

Moreover, in many cases, a company's corrective disclosure will be accompanied by other new information, which may be either good or bad. Ultimately, to survive a motion for summary judgment, a plaintiff will need to present evidence that isolates the price impact of the allegedly misstated information. *See, e.g., In re Warnaco Group Sec. Litig.*, 388 F. Supp. 2d 307, 317 (S.D.N.Y. 2005).

Dura also plays a role at the *Daubert* stage of a case. The *Dura* court noted several factors besides fraud that could cause a stock price to decline, but it did not explain how plaintiffs are to go about proving their damages when some of these other factors exist. Nonetheless, given the Court's mandate that plaintiffs must link their losses to alleged misrepresentations or omissions, any damage models that do not exclude stock price fluctuations attributable to factors other than the alleged misrepresentations or omissions are of questionable validity, including some of the more plaintiff-friendly models such as the various constant ribbon methodologies and the index method model. Jonathan C. Dickey & Marcia Kramer Mayer, *Effect on 10b-5 Damages of the 1995 Private Securities Litigation Reform Act: A Forward-Looking Assessment*, 51 Bus. Law. 1203, 1204 (1996) (discussing various 10b-5 damage models).

Likewise, plaintiffs traditionally allege class periods that are as lengthy as possible to increase the potential amount of recoverable damages. Such damages periods may be vulnerable under *Dura* on the grounds that at least some portion of the stock decline during the class period will have occurred before any corrective disclosure, as a result of other factors unrelated to the allegedly fraudulent misstatements. Finally, plaintiffs' experts should no longer be able to assert damages for "in and out" traders who have sold their stock before there is a corrective disclosure. *See Sawtek*, 2005 WL 2465041, at *12.

CONCLUSION

Dura brought a fundamental change to the law of loss causation in the securities arena. In the brief span since the Supreme Court's decision, the case has been cited more than 250 times. The decision will likely receive similar attention in the future as litigants and courts wrestle with the scope of the decision. ■

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COMPANIES

Securities Disputes Raise Procedural Dilemmas

UNDER SIEGE:

and Related Issues

By Michael L. Davitt and James P. Karen

THE CHALLENGE

Securities-fraud lawsuits and governmental investigations are not new. In fact, whenever public companies have decided to disclose what could be considered unwelcome news, they have always kept a wary eye open for class-action plaintiffs' lawyers and various governmental bodies. However, today more than ever before, companies seem to be besieged by a battery of securities-fraud lawsuits, derivative lawsuits, ERISA claims, and governmental investigations where, in the past, they might have faced only a securities-fraud lawsuit and/or an investigation. The pendency of these types of claims and investigations, with different but related issues, varying standards of proof, and disparate civil and possibly criminal remedies, presents counsel with critical issues and judgment calls at each stage, particularly at the outset. In this article, we identify some of these issues and examine the practical considerations that go into addressing them.

INITIAL REPRESENTATION AND INVESTIGATORY ISSUES

Representational Issues. It is natural for a company facing a battery of claims in different forums to reach out to one law firm to represent it, as well as some or all of its current and former directors and officers. This approach is clearly defensible, since the various lawsuits and investigations traditionally involve a common nucleus of facts and issues. However, the ability of a company to retain one law firm to protect it may be compromised by various conflict and other representational issues. Without question, a great deal of thought and analysis must, at the outset, go into understanding the issues that exist and determining which firms may be available to represent particular defendants and targets.

Three primary considerations are at play here. First, legal conflicts may prevent a single law firm from representing a company as well as its officers and directors. By way of example, while it may be totally appropriate for a single law firm to represent the company and its executives as defendants in a securities-fraud lawsuit, that same firm may not be able to represent the company and its executives simultaneously through trial in the related derivative action. After all, a derivative action in this context is, by definition, a claim brought *on behalf of* the company *against* certain of the officers and directors.

Second, in this day and age, it is important for companies to recognize that different types of claims require different, often highly targeted legal skills. Securities litigators are often tapped to handle securities fraud and even shareholder derivative lawsuits. However, those lawyers may or may not have the requisite experience to handle a civil or criminal investigation, normally the mainstay of lawyers with prosecutorial or SEC experience. Furthermore, many companies are now facing lawsuits alleging that they, along with certain officers and directors, violated fiduciary and other obligations under ERISA. Those kinds of allegations require highly experienced lawyers with an understanding of the ERISA laws and the fiduciary obligations imposed upon those who manage and/or oversee a company's employee benefit plans.

Third, while it is very common for current and former officers and directors to be sued along with the company, and for each of them to believe and want to argue that their conduct and that of the company was aboveboard, individual defendants, particularly if they no longer are employed at the company, may have vastly different concerns and expectations as to timing, extent of involvement, willingness to incur risks, and feasible outcome. In this vein, it is important to acknowledge that former officers and directors who may have devoted years of loyal service to the company may now value a quick resolution, no matter the cost to the company, over what may otherwise be in the interests of the company. The bottom line is that former officers and directors and, sometimes, current officers and directors may require separate counsel.

WITHOUT QUESTION, A

go into understanding and determining which

Board Investigations. Management and the directors of a company may have a duty to investigate the facts that gave rise to litigation, or they may simply want to do so. At times, a company may be able to halt derivative litigation by forming a special committee to investigate allegations asserted in a derivative lawsuit. Beyond this, many companies have internal audit departments that either have been monitoring the issues giving rise to litigation or will want to do so. Those departments usually view it as part of their regular obligations to initiate investigations following the assertion of claims.

The discharge by the board and/or management of their respective duties to investigate is crucial, but it must be weighed against the need to protect the company in litigation. This involves numerous considerations. Investigations may be required by the proper discharge of the board's duties or management's. Thus, the failure to investigate may itself be actionable. But on the other hand, the initiation of an investigation must be tempered by the realities. While an early investigation may take advantage of the fact that the events are fresh and related documents are readily available, the record may be incomplete, or if complete, not totally understood. And while the desire to move quickly is human

GREAT DEAL OF THOUGHT AND ANALYSIS MUST, AT THE OUTSET,

firms may be available to represent particular defendants and targets.

nature, a "rush to judgment" must be avoided at all costs. This is especially the case where lawsuits or governmental investigations have been commenced, since an internal investigation may well provide a discoverable road map to actual or prospective plaintiffs or investigators.

In-house legal investigations or reviews may not be immune from these concerns. While such investigations may well be privileged, such privileges are waivable, especially when the results have been provided to auditors, outside investigators, or even governmental investigators on a selective basis. Certainly, no in-house law department relishes the prospect of its own investigations being used against the company's interests.

DEFENDING THE COMPANY/CLAIMS ADMINISTRATION AND DEFENSE

Coordination of the various actions and/or investigations will prove to be a substantial—and very important—task that the company and its counsel must undertake. It is one of the issues that will need to remain in the forefront of the strategic thinking process throughout the course of the matters. The company and its counsel will need to treat the various actions and investigations as pieces of a single coordinated defense effort because of the impact that a misstep or shortsighted decision in one matter may have on the overall defense.

Accordingly, just as developing a case theme early in the defense of an action is important to shape the defense efforts, development of a consistent story across various actions is essential to the successful management of the slate of actions. This is particularly true because of the often public nature of these actions, the possibility that multiple actions may be before a single court or federal district, and the potential for information sharing among plaintiffs and/or governmental investigatory agencies. Failing to present a consistent defense among the various matters risks loss of credibility before the court(s) and the creation of evidentiary and/or briefing fodder for the various plaintiffs.

Consolidation and Coordination of Claims and Actions. While it will rarely be possible to formally consolidate all claims against the company and its officers and directors in one forum, much can be accomplished if desired. The most basic step would be a consolidation of similar actions pending before the same state or federal court. Similarly, related federal actions—securities, ERISA, and/or shareholder derivative actions—may be consolidated through multidistrict litigation ("MDL") proceedings. Once MDL treatment is secured, informal coordination of state-court cases under the MDL "banner" may also be possible. Formal coordination may not be feasible among governmental investigations or between civil litigation and governmental investigations. That said, in certain instances, a court or investigatory agency may give deference to or receive input from the other (*e.g.*, through *amicus curiae* submissions, etc.).

One issue to be considered is whether global or large-scale consolidation is necessarily the best course given the circumstances and dynamics at issue in a specific situation. Although consolidation may present numerous perceived benefits to the defense, it will also serve to decrease plaintiffs' costs and may enhance the pressure imposed by the court to settle early (which may or may not be perceived by the defendants as a negative factor).

Almost certainly, the employment of a joint defense arrangement among some or all defendants—whether formal or

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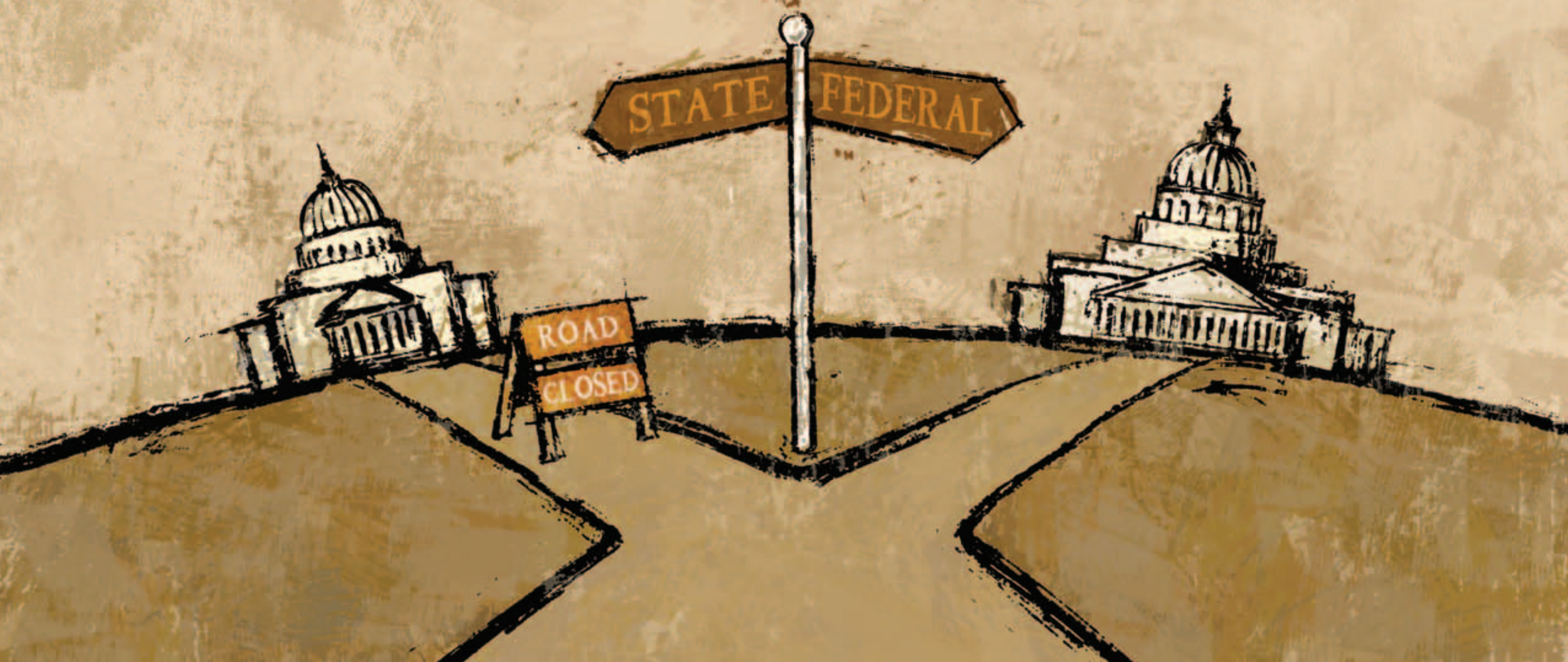
Whither Securities Class Actions?

By Robert H. Klonoff and David L. Horan



Through the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4 ("PSLRA"), and the Securities Litigation Uniform Standards Act of 1998, 15 U.S.C. §§ 77p and 78bb ("SLUSA"), Congress attempted to address abuses in securities-fraud class actions. The PSLRA was enacted to target what Congress perceived as "nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests, and manipulation by class-action lawyers of the clients whom they purportedly represent [that] had become rampant" and had "resulted in extortionate settlements, chilled any discussion of issuers' future prospects, and deterred qualified individuals from serving on boards of directors."

Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 126 S. Ct. 1503, 1510-11 (2006) (internal quotation marks omitted). To that end, the PSLRA reformed several rules governing securities class actions in federal court, including new restrictions on the selection and compensation of lead plaintiffs. 15 U.S.C. § 78u-4. SLUSA was enacted three years after the PSLRA to respond to plaintiffs' attorneys' efforts to avoid the PSLRA's reforms by bringing class actions under state law in state court. To curb this trend, SLUSA prohibits state-law class actions that properly belong in federal court as federal securities-fraud actions from going forward in state court. It also permits defendants to remove such cases to federal court. 15 U.S.C. §§ 77p, 78bb; *Dabit*, 126 S. Ct. at 1511-12.

In the years following the Acts' passage, their scope and operation have been hotly contested in the federal courts. In particular, courts have addressed several issues, including: (1) whether SLUSA prohibits a state-law securities-fraud class action from being litigated in state court even when the plaintiff would not have a claim in federal court under federal law; (2) whether a defendant sued for securities fraud in federal court should be allowed to opine on which plaintiff should be appointed lead plaintiff under the PSLRA; and (3) whether a court can properly group together multiple, unrelated plaintiffs as lead plaintiffs under the PSLRA.

THE SUPREME COURT RULES THAT CONGRESS DID NOT CARE WHETHER PLAINTIFFS COULD "MAKE A FEDERAL CASE OUT OF IT"

It is well established under federal securities laws that only investors who bought or sold stocks, and not mere "holders," can sue for securities fraud in federal court. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731-36 (1975). In one of the most closely watched securities decisions in years, the Supreme Court recently resolved a disagreement among the federal courts as to whether SLUSA nonetheless precludes *state*-court securities-fraud class actions brought by mere "holders" of stocks. In a major victory for stock issuers, the Court held (8 to 0) in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503 (2006), that SLUSA prohibits such cases from going forward as class actions in state court.

SLUSA provides that no "covered class action"—which includes any case brought as a class action on behalf of 50 or more persons—can proceed in state court "based upon [state law] . . . by any private party alleging . . . an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security." 15 U.S.C. §§ 77p(b)(1), 77p(f)(2)(A), 78bb(f)(1), 78bb(f)(5)(B)(i)(I). The Supreme Court held that SLUSA prohibits any such class action from proceeding in state court regardless of whether the plaintiff has a private remedy under federal law. The Court noted that "[t]he magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated." 126 S. Ct. at 1509. The Court observed that, under the language Congress enacted in SLUSA, the identity of the plaintiffs simply does not determine whether a complaint in state court alleges "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." *Id*. at 1511. Rather, the key determination is whether the alleged conduct can be said to have been "in connection with the purchase or sale of a covered security," *id*., and the Court concluded that, given its broad interpretation of this same language in related statutes and the policy behind SLUSA, "[t]he misconduct of which [the plaintiff] complains here—fraudulent manipulation of stock prices—unquestionably qualifies as fraud 'in connection with the purchase or sale' of securities," *id*. at 1515. The *Dabit* Court observed that a contrary ruling by the Court "would give rise to wasteful, duplicative litigation" because "[f]acts supporting an action by purchasers under Rule 10b-5 (which must proceed in federal court if at all) typically support an action by holders as well, at least in those States that recognize holder claims." *Id*. at 1514. The Court accordingly refused to interpret SLUSA to permit plaintiffs to bring "parallel class actions proceeding in state and federal court, with different standards governing claims asserted on identical facts." *Id*. The Court thus closed off a significant possible loophole in Congress's efforts to stem the tide of meritless class actions and thereby avoided a flood of state-court cases that was already rising in the wake of the PSLRA's enactment.

The importance of *Dabit* is clear. Indeed, the U.S. Chamber of Commerce filed an amicus brief urging the very outcome reached by the Court and predicted that, unless prohibited by SLUSA, state-law holder suits would "become the plaintiffs' vehicle of choice"—even though they "present the very dangers of abuse that led to enactment" of the PSLRA and SLUSA. Amicus Brief of the U.S. Chamber of Commerce in *Dabit*. Similarly, the Solicitor General urged the Court to rule that SLUSA prohibits these suits because a "contrary holding would open a gaping and illogical loophole by permitting potentially the most abusive securities class actions to escape SLUSA and the PSLRA, contrary to Congress's expressed intent to require such class actions to proceed only under uniform federal standards." Amicus Brief of the United States in *Dabit*.

Neither was the impact of *Dabit* on securities class actions lost on the popular press after the Court's decision was issued. *The Washington Times* explained that "the court delivered a broad-reaching opinion sure to block future class-action claims based on state law from being brought against firms that deal in the national securities market regulated by federal law." *The Washington Times*, Mar. 22, 2006, at C9. *Newsday* observed that "[t]he decision effectively ends such 'holder' class-action suits, because federal courts only allow class actions claiming securities fraud to be brought by people who say they actually bought or sold stock because of bad information." *Newsday*, Mar. 22, 2006, at A42. *BusinessWeek* similarly commented: "Big losers in the case: savvy lawyers seeking to have claims heard by sympathetic state judges." *BusinessWeek*, Apr. 3, 2006, at 30.

In fact, the impact of *Dabit* has already been dramatic, as numerous courts post-*Dabit* have dismissed alleged state-law claims as preempted by SLUSA. *E.g., In re Edward Jones Holders Litig*., 453 F. Supp. 2d 1210, 1214-17 (C.D. Cal. 2006) (violation of unfair competition statute and breach of fiduciary duty); *Mehta v. AIG SunAmerica Life Assur. Co. (In re Mut. Funds Inv. Litig.)*, 437 F. Supp. 2d 439, 443-44 (D. Md. 2006) (negligence); *In re Salomon Smith Barney Mut. Fund Fees Litig*., 441 F. Supp. 2d 579, 603-04 (S.D.N.Y. 2006) (breach of fiduciary duty); *Felton v. Morgan Stanley Dean Witter & Co*., 429 F. Supp. 2d 684, 692-95 (S.D.N.Y. 2006) (breach of contract).

FEDERAL COURTS SHARPLY DISAGREE ON WHETHER DEFENDANTS CAN HAVE A SAY IN WHICH PLAINTIFF TAKES THE LEAD

Once securities-fraud class actions are in federal court, the PSLRA governs the case. Importantly, in an effort to eliminate "lawyer-driven" securities litigation, the PSLRA requires the district court to appoint the lead plaintiff or plaintiffs early in the case. Lead plaintiffs serve an important role, including choosing their attorneys who will, with the district court's approval, serve as lead counsel for the proposed plaintiff class and then monitoring class counsel throughout the case. 15 U.S.C. § 78u-4(a)(3)(B)(v). Companies and individuals defending such actions will thus often have a real interest in who will serve as lead plaintiffs.

The PSLRA mandates that, 20 days after a case is filed, the plaintiffs' attorneys must publish a notice telling potential class members about the case and advising that, within 60 days of the notice, any potential class member may request that the district court appoint him or her as lead counsel. 15 U.S.C. § 78u-4(a)(3)(B)(i). Within 90 days of this notice, the district court must, based on any such requests, "appoint as lead plaintiff the member or members of the purported plaintiff class that the court determines to be most capable of adequately representing the interests of class members"—that is, the "most adequate plaintiff." *Id*. The district court, however, must:

> presum[e] that the most adequate plaintiff . . . is the person or group of persons that—[1] has either filed the complaint or made a motion in response to a notice []; [2] in the determination of the court, has the largest financial interest in the relief sought by the class; and [3] otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure [for a federal-court class action].

Id. § 78u-4(a)(3)(B)(iii)(I). This presumption "may be rebutted only upon proof by a member of the purported plaintiff class that the presumptively most adequate plaintiff—[1] will not fairly and adequately protect the interests of the class; or [2] is subject to unique defenses that render such plaintiff incapable of adequately representing the class." *Id*. § 78u-4(a)(3)(B)(iii)(II).

Some courts hold that defendants may provide evidence to oppose a plaintiff's appointment as lead plaintiff. *E.g., In re Flight Safety Techs., Inc. Sec. Litig*., 231 F.R.D. 124, 129-31 (D. Conn. 2005); *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. LaBranche & Co*., 229 F.R.D. 395, 405-06 (S.D.N.Y. 2004); *In re Terayon Communication Sys., Inc*., No. C-00-01967 MHP, 2004 WL 413277, at *6-*7 (N.D. Cal. Feb. 23, 2004). These courts have emphasized that the PSLRA requires district courts to be active in the selection process; that the process functions better with more and not less information; and that defendants can provide useful information, regardless of whether they have standing to formally oppose a plaintiff's motion for appointment. Indeed, the defendant in *Terayon* actually succeeded in defeating the lead-plaintiff bid of some short-selling plaintiffs. *Terayon*, 2004 WL 413277, at *8.

On the other hand, other courts have held that defendants cannot challenge a plaintiff's appointment as lead plaintiff. The Third Circuit has emphasized that "only class members may seek to rebut the presumption, and the court should not permit or consider any arguments by defendants or non-class members," *In re Cendant Corp. Litig*., 264 F.3d 201, 268 (3d Cir. 2001), "because defendants w[ould] rarely have the best interests of the class at heart," *In re Merck & Co. Sec. Litig*., 432 F.3d 261, 267 (3d Cir. 2005). At least one district court has likewise rejected defendants' attempts to challenge plaintiffs' suitability to serve as lead plaintiffs. *See In re Universal Access, Inc., Sec. Litig*., 209 F.R.D. 379, 383 (E.D. Tex. 2002).

Unless the remaining federal circuits join in the approach of the Third Circuit, this conflict will likely require resolution by the Supreme Court.

Once securities-fraud class actions are in federal court, the PSLRA governs the case. Importantly, in an effort to eliminate "lawyer-driven" securities litigation, the PSLRA requires the district court to appoint the lead plaintiff or plaintiffs early in the case.

FEDERAL COURTS ALSO DISAGREE ON HOW MANY UNRELATED "LEAD PLAINTIFFS" ARE TOO MANY

As a related matter, since the PSLRA allows a court to appoint a "group of persons" as lead plaintiff, 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I), can a court appoint a group of unrelated investors that a plaintiffs' lawyer or the court itself put together as lead plaintiffs? Courts disagree on whether they can do so and, if so, how many unrelated plaintiffs can be aggregated.

The vast majority of recent decisions have found that unrelated plaintiff class members can be grouped as lead plaintiffs, but the courts frequently adopt different approaches as to how many unrelated plaintiffs can be grouped together. In *In re Flight Safety Technologies, Inc. Securities Litigation*, 231 F.R.D. 124, 128-31 (D. Conn. 2005), the court decided that a proposed group of "eight unrelated and unfamiliar plaintiffs as co-lead plaintiffs" needed to be reduced in number to improve the overall efficiency of the litigation. Another court concluded that a group of three unrelated investors should be permitted to serve as lead plaintiffs where "it would be most beneficial to the class under the circumstances of [the] given case." *In re Star Gas Sec. Litig*., No. 3:04CV1766(JBA), 2005 WL 818617, at *4-*5 (D. Conn. April 8, 2005).

Other courts generally reach the same result but through different reasoning. In *In re eSpeed, Inc. Securities Litigation*, the court began by acknowledging two earlier New York courts' decisions that "forcefully assert[ed]" that "unrelated investors may not band together for the purpose of achieving lead plaintiff status." 232 F.R.D. 95, 99 (S.D.N.Y. 2005). The court disagreed with these courts' "minority" view and concluded that "[g]enerally, a lead plaintiff group should be held to a reasonable number [generally not more than five], so that the group does not become too unwieldy." *Id*. A later decision applied a three-factor test in deciding that a group of six unrelated plaintiffs was not too many: (1) the size of the proposed group, (2) the intentions behind the group's formation, and (3) the plaintiffs' relationship. *Barnet v. Elan Corp*., 236 F.R.D. 158, 161-63 (S.D.N.Y. 2005).

The Third Circuit has similarly concluded that no preexisting relationship is required for multiple lead plaintiffs. *In re Able Labs. Sec. Litig*., 425 F. Supp. 2d 562, 567-68 (D.N.J. 2006) (citing *In re Cendant Corp. Litig*., 264 F.3d 201, 266 (3d Cir. 2001)). Lawyers, however, may not create groups simply to meet the PSLRA's largest-financial-interest requirement, and any group

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By

Robert W. Gaffey

The Antifraud Provisions of the U.S. Securities Laws: IN GLOBAL MARKETS, JUST HOW FAR CAN THEY REACH?

As cross-border securities transactions continue to become more common in ever more globalized markets, plaintiffs' attorneys predictably will continue to push the extraterritorial limits of the antifraud provisions of the U.S. federal securities laws. The last several years have seen increasing numbers of non-U.S. issuers named as defendants in securities-fraud class actions. It also is no longer unusual to see non-U.S. investors as plaintiffs in such cases, including as lead plaintiffs. The extraterritorial reach of the U.S. securities laws is not endless, but it is expansive. One area that bears watching is whether the federal courts will allow U.S. securities actions to be maintained by non-U.S. investors who purchased the securities of non-U.S. issuers on non-U.S. exchanges. Some courts have allowed such claims to proceed, while other courts have not.

THE RISE IN LITIGATION INVOLVING NON-U.S. ISSUERS

Non-U.S. plaintiffs' attraction to the U.S. courts, and would-be plaintiffs' attempts to bring non-U.S. defendants before U.S. courts, are understandable, given the characteristics of litigation in the United States that differentiate it from litigation in most other countries. Extensive and intrusive pre-trial discovery is available in U.S. litigation, helping plaintiffs to "build" their cases after filing them. Punitive damages can be sought. Plaintiffs' counsel can recover contingency fees. There is less risk for a plaintiff because the so-called "American rule" applies with respect to attorneys' fees; unsuccessful plaintiffs do not usually have to pay the defendants' fees and costs. Securities-fraud cases can be pursued as class actions, seeking damages on behalf of thousands of absent class members. And, last but not least, liability is often decided by a jury, not by the judge.

Thus, it is not particularly surprising that, with the number of securities-fraud class actions climbing in recent years and the settlement amounts growing larger, plaintiffs have shown a steady inclination to reach overseas to find additional defendants. In 2004, when the total number of securities-fraud class-action filings reached a record high of 203 new cases, the number of suits against non-U.S. issuers rose right along with it, to a record 29 such suits filed against non-U.S. companies (a 93 percent increase over the prior year). According to PricewaterhouseCoopers' "2005 Securities Litigation Study," in 2005 the total number of cases filed dropped somewhat (to 19 cases against non-U.S. issuers), but it still was the third-highest number of the last 10 years, and the proportion of cases against non-U.S. issuers remained roughly the same. In sum, it has become more common for investors to assert claims in U.S. courts against non-U.S. defendants. And, perhaps because of the increased frequency with which sophisticated institutional investors have initiated securities-fraud class actions, it also has become more common to see non-U.S. plaintiffs venturing into the U.S. courts.

Few substantial subject-matter jurisdiction issues are presented when a non-U.S. investor purchases shares of an American company on an American exchange. Likewise, the existence of federal subject-matter jurisdiction is unremarkable when an investor, U.S. or not, has purchased a non-U.S. corporation's American Depositary Receipts or American Depositary Shares on a U.S. exchange. In each circumstance, the plaintiff alleges that it has suffered loss through activity directly related to the U.S. securities markets. A more difficult issue arises, however, when a non-U.S. investor who purchased securities of a non-U.S. corporation on a *non-U.S.* exchange asserts claims under the U.S. securities laws. In that case, the extraterritorial application of the U.S. securities laws should face higher hurdles, given that such cases may have an attenuated connection to the United States.

THE EXTRATERRITORIAL APPLICATION OF THE SECURITIES LAWS

The Securities Exchange Act bestows upon federal courts exclusive subject-matter jurisdiction to hear claims under the U.S. securities laws (*see* 15 U.S.C. § 78aa), but it is silent about the question of extraterritorial application. Federal courts examining the securities laws' extraterritorial reach, in cases stemming from "predominantly foreign" frauds, have therefore sought to "determine whether Congress would have wished [that] the precious resources of the United States courts . . . be devoted to them rather than leave the problem to foreign countries." *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 985 (2d Cir. 1975), *cert. denied*, 423 U.S. 1018, 96 S. Ct. 453 (1975); *see also Tri-Star Farms Ltd. v. Marconi, PLC*, 225 F. Supp. 2d 567, 571–72 (W.D. Pa. 2002).

In this regard, the federal courts have developed two tests to determine whether their subject-matter jurisdiction should extend to cases involving non-U.S. frauds. One analysis—the "conduct" test—focuses on whether conduct within the United States is alleged to have played some part in the perpetration of a securities fraud on investors outside the country. *See, e.g., Europe and Overseas Commodity Traders, S.A. v. Banque Paribas London*, 147 F.3d 118, 125–26 (2d Cir. 1998), *cert. denied*, 525 U.S. 1139, 119 S. Ct. 1029 (1999); *Cromer Finance Ltd. v. Berger*, 137 F. Supp. 2d 452, 479–80 (S.D.N.Y. 2001). The other analysis—the "effects" test—focuses on whether conduct outside the United States had a substantial adverse effect on United States investors or United States securities markets. *See Tri-Star Farms Ltd.*, 225 F. Supp. 2d at 571–76. Satisfaction of either test may independently establish jurisdiction. *See Robinson v. TCI/US West Communications Inc.*, 117 F.3d 900, 905 (5th Cir. 1997).

Some courts have held that non-U.S. plaintiffs who did not purchase securities on a U.S. exchange cannot invoke subject-matter jurisdiction in federal courts over securities-law claims under the "effects" test. *See Tri-Star Farms Ltd.*, 225 F. Supp. 2d at 573. Even where other investors in the same securities were U.S. citizens or non-U.S. citizens purchasing securities on a U.S. exchange, these courts have held that non-U.S. plaintiffs who purchased their securities outside

Plaintiffs have continued to knock on the extraterritorial door, asserting claims based upon non-U.S. purchases of non-U.S. securities by non-U.S. investors, ALL BY SEARCHING FOR SOME ALLEGED CONNECTION TO THE UNITED STATES.

the United States cannot ride the coattails of U.S. investors into the U.S. courts. *See, e.g., McNamara v. Bre-X Minerals, Ltd.*, 32 F. Supp. 2d 920, 923–24 (E.D. Tex. 1999); *Kaufman v. Campeau Corp.*, 744 F. Supp. 808, 810 (S.D. Ohio 1990).

Non-U.S. plaintiffs seeking to invoke the subject-matter jurisdiction of United States courts therefore must usually do so on the basis of the defendant's relevant conduct within the United States. Under the "conduct" test, the plaintiff bears the burden of justifying the court's exercise of jurisdiction by showing, in part, that the defendant's conduct within the U.S. was substantial in comparison to the allegedly fraudulent conduct committed outside the United States. *See Europe and Overseas Commodity Traders, S.A.*, 147 F.3d at 126–28. In a seminal decision, the Second Circuit established the threshold requirements of the "conduct" test. It held that the antifraud provisions of the federal securities laws "[d]o not apply to losses from sales of securities to foreigners outside the United States unless acts (or culpable failures to act) within the United States directly caused such losses." *Bersch*, 519 F.2d at 993. The *Bersch* court went on to state that non-U.S. plaintiffs may not assert claims under federal securities laws "where the United States activities are merely preparatory or take the form of culpable nonfeasance and are relatively small in comparison to those abroad." *Bersch*, 519 F.2d at 997 (holding that plaintiffs failed to invoke the court's subject-matter jurisdiction, despite United States conduct that included meetings of attorneys, underwriters, and accountants in New York to initiate, organize, and structure the securities offering at issue; retention of a New York law firm to represent the underwriters; and meetings with the SEC).

A NON-U.S. PLAINTIFF, A NON-U.S. DEFENDANT, AND A NON-U.S. EXCHANGE

Based upon *Bersch* and its progeny, many courts have held that putative non-U.S. plaintiffs may not initiate litigation in the United States under American securities laws when the non-U.S. investor purchased its securities on a non-U.S. exchange. *See, e.g., Tri-Star Farms Ltd.*, 225 F. Supp. 2d at 576–81 (no subject-matter jurisdiction to hear claims of non-U.S. plaintiffs who purchased securities outside the United States where the alleged fraudulent scheme was conceived in the United Kingdom by British citizens and involved shares of a British corporation traded on a non-U.S. exchange, and non-U.S. citizens were responsible for the alleged wrongful misrepresentations and omissions); *Fidenas AG v. Compagnie Internationale Pour L'Informatique CII Honeywell Bull S.A.*, 606 F.2d 5, 7–10 (2d Cir. 1979) (affirming dismissal for lack of subject-matter jurisdiction where nearly all of the acts complained of took place outside the United States, the plaintiffs were non-U.S. companies and a non-U.S. person, and all but one of the defendants were non-U.S. companies).

Plaintiffs, however, have continued to knock on the extraterritorial door, asserting claims based upon non-U.S. purchases of non-U.S. securities by non-U.S. investors, all by searching for some alleged connection to the United States. In recent cases, these attempts have met with mixed results. Some courts have recognized few borders and adopted the apparent view that information released to investors in one country, once disseminated, has a global reach. Others have adhered to the more conservative view that the span of information, and the reach of U.S. law, is not endless.

One good example of a court taking a broad view of the reach of the Exchange Act was in *In re Vivendi Universal S.A. Sec. Litig.*, 381 F. Supp. 2d (S.D.N.Y. 2003). There, a putative class brought securities-fraud claims contending that Vivendi, a French corporation that was not registered to do business in the U.S., inflated its stock price through various false and misleading statements made in connection with Vivendi's American Depositary Receipt filings and otherwise made in the United States. Vivendi moved to dismiss for lack of subject-matter jurisdiction the claims brought by non-U.S. members of the purported class who had bought Vivendi stock on markets outside the United States. Applying the "conduct" test, the court denied the motion, based in substantial part on the fact that some of the purportedly false statements were made after Vivendi's chief executive officer and chief financial officer had relocated to New York "allegedly to better direct corporate operations [of Vivendi subsidiaries] and more effectively promote misleading perceptions on Wall Street. . . ." On the basis of those allegations, the court essentially viewed the global financial markets as without informational borders, finding that it would be reasonable to infer that "the alleged fraud on the American exchange was a 'substantial' or 'significant contributing cause' of foreign investors' decisions to purchase Vivendi's stock abroad." *Id*.

Subject-matter jurisdiction over similar claims of non-U.S. investors was also sustained in *Royal Dutch/Shell Transport Sec. Litig.*, 380 F. Supp. 2d 509 (D.N.J. 2005). There, plaintiffs alleged that defendants had disseminated false statements about the level of Royal Dutch/Shell's oil reserves, which artificially inflated the purchase price of their stock. Again, defendants argued that the court lacked subject-matter jurisdiction over the claims of non-U.S. nationals in the putative class who purchased their shares on exchanges outside the U.S. Defendants argued that the United States was not the location of "substantial and material" conduct because the companies were European companies that ran their operations from European headquarters, and the "focal point" of alleged fraudulent activity was in the United Kingdom and the Netherlands. Defendants also asserted that roughly 92 percent of the defendant companies' shares were traded outside the United States. 380 F. Supp. at 539, 541.

The court denied the motion, finding that subject-matter jurisdiction could be based on allegations that some work in calculating reserves, some auditing of reserves, and some presentations to analysts and investors took place in the United States. To distinguish other cases where jurisdiction had been found lacking, the court in *Royal Dutch/Shell Transport* rejected as "oversimplified" the assertion that these activities were pertinent only to United States investors. Coming close to finding international markets to be fungible from the standpoint of information dissemination, the court found that "[j]ust as foreign stock exchange data and information is pertinent to United States investors, the reverse is also true." 380 F. Supp. at 545. Thus, the court held, "[t]he Companies' alleged fraudulent conduct which took place in the United States would, therefore, affect foreign as well as domestic investors." *Id*.

In contrast to *Vivendi* and *Royal Dutch/Shell Transport*, other courts have not found allegations of United States activity so easily connected to investment decisions made by investors outside the United States effecting transactions on non-U.S. markets. In *Blechner v. Daimler-Benz AG*, 410 F. Supp. 2d 366 (D. Del. 2006), the court expressly declined to follow the rationale of *Royal Dutch/Shell Transport*, emphasizing instead the general canon of statutory interpretation that "[u]nless Congress has expressed intent otherwise, courts should avoid the extraterritorial application of laws." 410 F. Supp. 2d at 368. Against that more conservative backdrop, the *Blechner* court rejected for lack of subject-matter jurisdiction securities-fraud claims asserted by a putative class of non-U.S. investors who purchased, or otherwise acquired by exchanging their shares in Chrysler Corporation, shares in a German company, DaimlerChrysler AG. Plaintiffs alleged that defendants had made material misrepresentations, mischaracterizing the merger of Daimler-Benz and Chrysler as a "merger of equals" when, in fact, it was an acquisition of Chrysler. The alleged class of plaintiffs included non-U.S. investors who made their purchases or exchanges "through a securities exchange not based in the United States." 410 F. Supp. 2d at 367.

The *Blechner* court found that the conduct alleged to have occurred within the United States was "not essential" to the alleged plan to defraud. 410 F. Supp. 2d at 371. Of particular interest, however, the *Blechner* court appears to have rejected the "information is globally fungible" approach of the courts in *Vivendi* and *Royal Dutch/Shell Transport*, finding no jurisdiction even though "the company acquired was an American corporation and . . . many of the alleged victims of the fraud were American. . . ." 410 F. Supp. 2d at 371. Taking a stricter view about extraterritoriality, the court found no subject-matter jurisdiction existed because, as to the plaintiffs themselves, "the investors are not American, did not use an American exchange, and did not suffer any effects of the alleged wrongful conduct in the United States." *Id*. at 373. Applying the "conduct" test, the court found that "the conduct that comprises plaintiffs' claims occurred predominantly outside the United States."

In a similarly conservative opinion, the court in *In re: Bayer AG Sec. Litig.*, 423 F. Supp. 2d 105 (S.D.N.Y. 2005), also found no subject-matter jurisdiction under the "conduct" test. Plaintiffs asserted that defendants Bayer AG (a German company) and Bayer Corp. (an Indiana corporation based in Pennsylvania) had disseminated false and misleading statements in the United States (i) to obtain FDA approval for the drug Baycol and (ii) in statements concerning Baycol made in registration statements filed with the SEC when Bayer AG decided to offer securities for sale in the United States.

Even in light of those allegations of U.S.-based conduct, the court found no subject-matter jurisdiction. The court noted that, even as to the statements made in SEC filings, it was appropriate to "consider whether the documents at issue 'emanated from a foreign source.' " 423 F. Supp. 2d at 112. The court found that the statements in Bayer AG's SEC filings ultimately emanated from Germany, not from conduct in the United States. Hence, the court held that subject-matter jurisdiction was absent because the filing could not "support an extension of jurisdiction over an overwhelmingly foreign putative class." *Id*.

As in *Blechner* and *Bayer*, the court in *Burke v. China Aviation Oil (Singapore) Corp. Ltd.*, 421 F. Supp. 2d 649 (S.D.N.Y. 2005), declined to find subject-matter jurisdiction under the "conduct" test after determining that access to a company's web site in the United States was not by itself sufficient conduct in the U.S. to confer jurisdiction. In *Burke*, a New York shareholder brought a securities-fraud class action against a Singapore issuer whose shares traded on non-U.S. exchanges but could be purchased in the U.S. through the Over-the-Counter Bulletin Board. *Id.* The court found that the issuer did not intentionally market its stock in the U.S., notwithstanding the ability of U.S. investors to access the issuer's web site in the U.S. *Id.* at 653. It held that "U.S. investors in clicking on the [issuer's] website took the action which could cause the information to be transmitted to the United States." *Id.* In so holding, the court noted that "[w]ere the Court to view it otherwise, any foreign corporation with a website would be subject to securities fraud litigation in the United States if a United States resident had bought its securities from some market maker in this country." *Id.*

In a similarly conservative approach, the Southern District of New York recently decided in *In re Nat'l Australia Bank Sec. Litig.*, No. 03 Civ 6537, 2006 WL 3844465 (S.D.N.Y. Oct. 25, 2006), that no subject-matter jurisdiction existed over an Exchange Act Section 10(b) class action when non-U.S. acts, and not U.S. acts, directly caused the losses of the lead non-U.S. plaintiffs. The action involved both lead non-U.S. and lead U.S. plaintiffs. The lead non-U.S. plaintiffs were Australian residents who claimed that they were defrauded in the purchase of defendant issuer's shares that traded on an Australian securities exchange, and the lead U.S. plaintiff was a U.S. resident who purchased quantities of issuer's ordinary shares in the form of American Depositary Receipts. *Id.*

The court, following *Bersch*, found that "where the effects of an alleged fraud are predominantly foreign, the amount of domestic conduct and its nexus to the alleged injury required to sustain jurisdiction is at its greatest." *Id.* at *3. The court added that this rule is "especially true in a class action involving both foreign and domestic plaintiffs . . . where the danger exists that a 'very small tail' may be 'wagging an elephant'." *Id.* The court dismissed the action after finding, among other things, that there was no subject-matter jurisdiction over the non-U.S. plaintiffs' claims. *Id.* at *8–9. Only the lead U.S. plaintiff was given leave to file an amended complaint. *Id.* at *9.

CONCLUSION

The debate about the application of the antifraud provisions of the U.S. securities laws to non-U.S. purchasers on exchanges outside the United States clearly is not over. We can expect plaintiffs' attorneys to continue to search for a way to plead a viable U.S. nexus in securities-fraud cases where—as is now often the case—non-U.S. purchasers are

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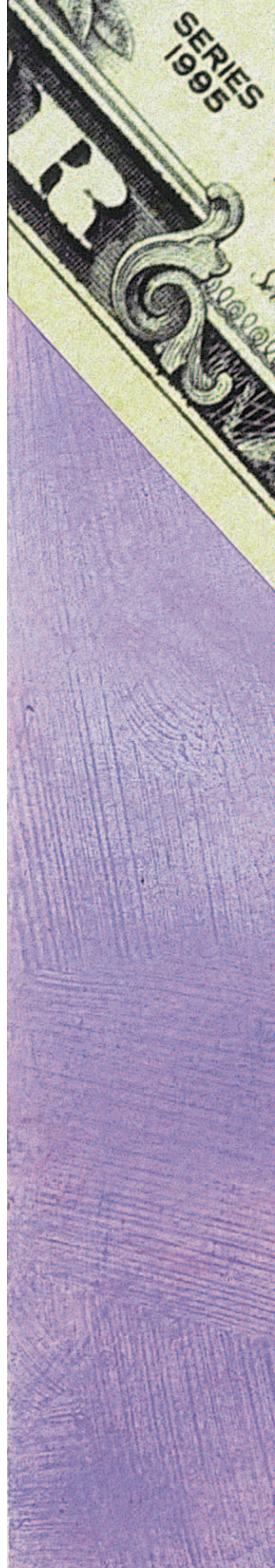
The SEC's BALANCING Act:

Financial Penalties Against Corporations

By Harold K. Gordon

Newspaper headlines announcing a Securities and Exchange Commission ("SEC") action seeking a multimillion-dollar penalty against a corporation seem to have appeared monthly in recent years. For most of its 73-year history, however, the SEC policed the Federal Securities Laws primarily by seeking injunctions against future violations and disgorgement of ill-gotten profits, or by bringing administrative proceedings against registered securities firms and their personnel. Not until 1984 did Congress give the SEC the authority to seek civil money penalties, and at that time it could pursue penalties only for insider-trading violations. Congress gave the SEC significant additional enforcement tools in 1990, including the ability to impose administrative cease-and-desist orders, and to seek a court order preventing an individual from serving as a corporate officer or director and imposing financial penalties against individuals or corporations for any violation of the Federal Securities Laws. Following criticism from the defense bar and some of its own Commissioners that SEC financial penalties against corporations were inconsistent and frequently

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served to unfairly punish innocent shareholders already victimized by the corporation's misconduct, in January 2006 the SEC issued a statement attempting to clarify the factors it will consider in determining when to seek a monetary penalty against a corporation. Though questions remain, those in the executive suite and the corporate defense bar welcomed the SEC's rare illumination of its decision-making process regarding corporate penalties.

THE SEC'S PENALTY AUTHORITY

With the passage of the Insider Trading Sanctions Act of 1984, the SEC obtained the ability to seek civil money penalties for insider trading. Based on the perception that the securities industry was not exercising sufficient vigilance in detecting and preventing insider trading, in 1988 Congress enacted the Insider Trading and Securities Fraud Enforcement Act ("ITSFEA"). Pursuant to ITSFEA, broker-dealers, investment advisors, and other securities firms must establish policies and procedures designed to detect and prevent insider trading by their employees. Congress also gave the SEC the authority under ITSFEA to request that a court impose substantial financial penalties not only on a person who engaged in insider trading, but on the firm that employed the insider trader and his supervisors if they knew or recklessly disregarded the fact that he was likely to engage in insider trading and failed to take sufficient steps to prevent it. ITSFEA also authorizes the SEC to seek penalties against the firm and supervisors if they intentionally or recklessly failed to establish sufficient policies and procedures required to prevent insider trading and that failure led to the employee's insider trading. Last June, the SEC obtained a $10 million penalty from Morgan Stanley & Company Inc. for an alleged failure to maintain and enforce sufficient written policies and procedures designed to prevent the misuse of material, nonpublic information by Morgan Stanley and its employees. In March 2007, Banc of America Securities LLC agreed to pay a $6 million penalty in settlement of alleged violations of the same securities-firm compliance requirement.

Efforts to provide the SEC with authority to pursue financial penalties outside the insider-trading context for any Federal Securities Law violation originated with a report issued in 1987 by the National Commission on Fraudulent Financial Reporting, known as the Treadway Commission. The Treadway Commission was a private-sector group sponsored by the accounting profession to identify ways to reduce the occurrence of fraudulent financial reporting by corporations. The Treadway Commission Report recommended that Congress enact legislation providing the SEC with the authority to seek civil money penalties for financial-reporting misconduct and other violations, along with bars against individuals serving as corporate officers and directors, and the authority to impose cease-and-desist orders, which are the administrative equivalent of a federal court injunction against further violations of the securities laws.

Congress adopted the Treadway Commission's recommended expansion of the SEC's enforcement arsenal in 1990 with the enactment of the Securities Enforcement Remedies and Penny Stock Reform Act ("Remedies Act"). The SEC's financial-penalty authority was added in Section 20(d)(1) of the Securities Act of 1933 and in Section 21(d)(3) of the Securities Exchange Act of 1934. Parallel penalty provisions were added to the Investment Company Act and the Investment Advisers Act. The SEC may seek a penalty whenever it believes that an individual or corporation has violated a Federal Securities Law statute or SEC rule, or a previously entered SEC cease-and-desist order, except for an insider-trading violation, which is covered by the separate ITSFEA penalty provisions. In federal court actions, the SEC has the burden of making a "proper showing" for the imposition of a financial penalty.

The amount of the financial penalty the SEC can request is governed by three tiers of potential penalties. The first tier authorizes the SEC to seek up to $5,000 in an action against an individual, up to $50,000 from a corporation, or the "gross amount of pecuniary gain" to a defendant as a result of the violation. The second tier increases the amounts of the penalties to $50,000 for an individual and $250,000 for a corporation (or the gross amount of pecuniary gain) if the violation involved "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement." The third tier raises the ceiling to $100,000 for an individual and $500,000 for a corporation (or the gross amount of pecuniary gain) if the violation involved the same conduct as the second tier and in addition directly or indirectly caused "substantial losses

With the passage of the Insider Trading Sanctions Act of 1984, the SEC obtained the ability to seek civil money penalties for insider trading.

or created a significant risk of substantial losses to other persons." Until passage of the Sarbanes-Oxley Act of 2002, penalties the SEC obtained were paid to the United States Treasury. Section 308 of the Sarbanes-Oxley Act, the so-called "Fair Funds provision," permits the SEC to request that penalties be added to any disgorgement fund established as part of an SEC enforcement action to return money to shareholders, investors, or other victims of the defendant's securities-law violations.

Despite the SEC's vital mission, not everyone favored giving the agency the authority to seek financial penalties outside the insider-trading context. Some believed that doing so was contrary to the SEC's function as a regulatory agency and the traditionally remedial and forward-looking nature of the remedies the SEC sought in its enforcement actions, whether returning funds to aggrieved investors, obtaining an injunction against future violations, or suspending supervisors or others at registered securities firms pursuant to an administrative order. Penalties constituted a punitive remedy, the argument went, and such quasi-criminal actions in egregious cases were historically referred by the SEC to criminal prosecutors. In fact, the American Bar Association ("ABA") opposed the broad penalty authority the Remedies Act would provide the SEC. In a letter from the ABA's Subcommittee on SEC Practice and Enforcement Matters to Senator Donald Riegle, Jr., chairman of the Senate Committee on Banking, Housing, and Urban Affairs, the ABA argued that the SEC should be granted authority for monetary penalties for specific violations, like insider trading, only where the SEC had shown that its existing remedies were inadequate. The ABA also contended that penalties should not be available for negligent violations or for "failure to supervise" violations, noting that SEC penalties would trigger jury-trial rights and double-jeopardy issues that could preclude or complicate criminal prosecutions and generally undermine the effectiveness of the SEC's enforcement program. Some practitioners warned that the SEC would inevitably seek penalties excessively, encouraging litigation over settlements and focusing the agency's enforcement program on punitive instead of remedial relief.

Congress and the SEC attempted to assure those who feared the results of expanded penalty authority that the SEC would exercise its new enforcement tool appropriately. The Senate Report accompanying the Remedies Act stated that it was not anticipated that the SEC would seek a monetary penalty in every case, especially in cases involving "isolated and unintentional conduct." S. Rep. No. 337, 101st Cong., 2d Sess. (1990). The legislative history indicates that Congress expected the SEC to be even more constrained in pursuing financial penalties against corporations. Fearing that such penalties would simply be passed through to shareholders, the Senate Report stated that penalties against corporations should be sought only when the shareholders benefited from the violation. Where the shareholders were the principal victims and would be harmed again by ultimately paying an SEC penalty, it was expected that the SEC would, where appropriate, seek penalties instead from the individual corporate

The Commission has historically been reluctant to impose civil penalties on public companies because of the negative impact such a penalty can have on shareholders who have already been victimized by the conduct being penalized.

officers or employees responsible for the corporation's misconduct. *Id.*

Richard Breeden, SEC chairman at the time the Remedies Act was enacted, confirmed in a letter to Senator Riegle that the SEC intended to seek penalties against corporations only when the violation resulted in an improper benefit to shareholders. In addition, in its memorandum in support of the Remedies Act, the SEC stated that the improper gain by a corporation and its shareholders that would be required to justify a penalty would not necessarily occur in a financial fraud case where the allegations concerned improper disclosure of financial performance:

> [I]n deciding whether and to what extent to assess a penalty against the issuer, the Commission may properly take into account its concern that civil penalties assessed against corporate issuers will ultimately be paid by shareholders who were themselves victimized by the violations. In a typical case of financial fraud in which an issuer overstates its earnings and revenues, for example, the only shareholders who reap a direct economic benefit are those who sell their shares at an inflated price before the fraud is exposed. By the time that an enforcement action is brought, a large percentage of the shareholders may consist of persons who purchased shares at a price that was artificially inflated as a result of the fraud. To assess a civil penalty in such a case against the issuer, as opposed to the individual officers who were responsible for the fraud, would appear to be inequitable.* [1]

The SEC provided similar reassurances more recently in its June 2003 court submission in support of the proposed settlement of its action against WorldCom, Inc. It stated:

> The Commission has historically been reluctant to impose civil penalties on public companies because of the negative impact such a penalty can have on shareholders who have already been victimized by the conduct being penalized. Due to this concern, the Commission has sought and obtained civil penalties against public companies in financial fraud cases on only a handful of occasions. [2]

THE SEC'S TRACK RECORD ON CORPORATE PENALTIES

In December 2005 remarks, SEC Division of Enforcement Director Linda Thomsen noted that since Xerox Corporation agreed in April 2002 to pay $10 million in penalties in a settled SEC financial-reporting and accounting action, the SEC had sought civil money penalties against only 25 public companies. A count of such actions on the SEC's web site from the Xerox action through December 2005 reveals no reason

* *Endnotes for this story appear on page 60.*

to dispute Thomsen's statement. What was nonetheless significant at the time of Thomsen's remark was the increasing size of SEC penalties, including penalties of $50 million against Vivendi Universal, $100 million against Bristol-Myers Squibb, $120 million against Royal Dutch Petroleum, $225 million against Computer Associates, $250 million against Qwest Communications, and $300 million against Time Warner Inc. Also troubling was that in a number of instances, the SEC appeared to contradict its assurances to Congress at the time the Remedies Act was passed that it would not seek financial penalties from a corporation where the shareholders were victims of the alleged securities-law violation and would only be victimized again by indirectly defraying the tab for any SEC penalties and by a further depressed stock price following news of an SEC enforcement action.

Those in the executive suite and the defense bar were not the only ones troubled by how the SEC had exercised its penalty authority. In a series of speeches to corporate trade groups and other organizations, SEC Commissioners Cynthia Glassman and Paul Atkins expressed their concern that shareholders were being unfairly penalized. In a December 2004 speech before the Annual Public Fund Boards Forum, Commissioner Glassman stated:

> Where a corporation's shareholders have benefited from the fraud, I believe that a monetary penalty against the company may be an appropriate punishment. However, in many recent financial fraud cases the victims of the corporate misconduct were the shareholders — typically in the form of a drastically reduced or even worthless stock value.[3]

Glassman emphasized the same concerns in a speech delivered in June 2005:

> If the shareholders have benefited from the fraud, then I would not normally oppose a penalty. But I cannot justify imposing penalties indirectly on shareholders whose investments have already lost value as a result of the fraud. Our use of so-called Fair Funds, provided by Sarbanes-Oxley, as a vehicle to return civil penalties to defrauded investors . . . leads to the anomalous result that we have shareholders paying corporate penalties that end up being returned to them through a Fair Fund[.] This gets a headline, but it makes no sense to me — it is form over substance.[4]

Commissioner Atkins expressed similar concerns on SEC penalties against corporations in February 2005 remarks in Atlanta before the National Association of Corporate Directors:

> Fundamentally, we also have to remember that the corporation may already have been punished through reputational and stock-price damage.
>
> Unless the corporation is a criminal enterprise, or the shareholders themselves have somehow benefited from the fraud to the detriment of other corporations or the marketplace as a whole, and the fine serves as a disgorgement of ill-gotten profits, fines against shareholders are often not appropriate. Corporations fined for disclosure-based transgressions use shareholder money to pay for behavior of which the shareholders were the victims. We have to ask ourselves: Who are the victims? Who really is paying the fines? By imposing such fines, are we not punishing the very people who might have already [been] punished through the marketplace when the stock price was clobbered?[5]

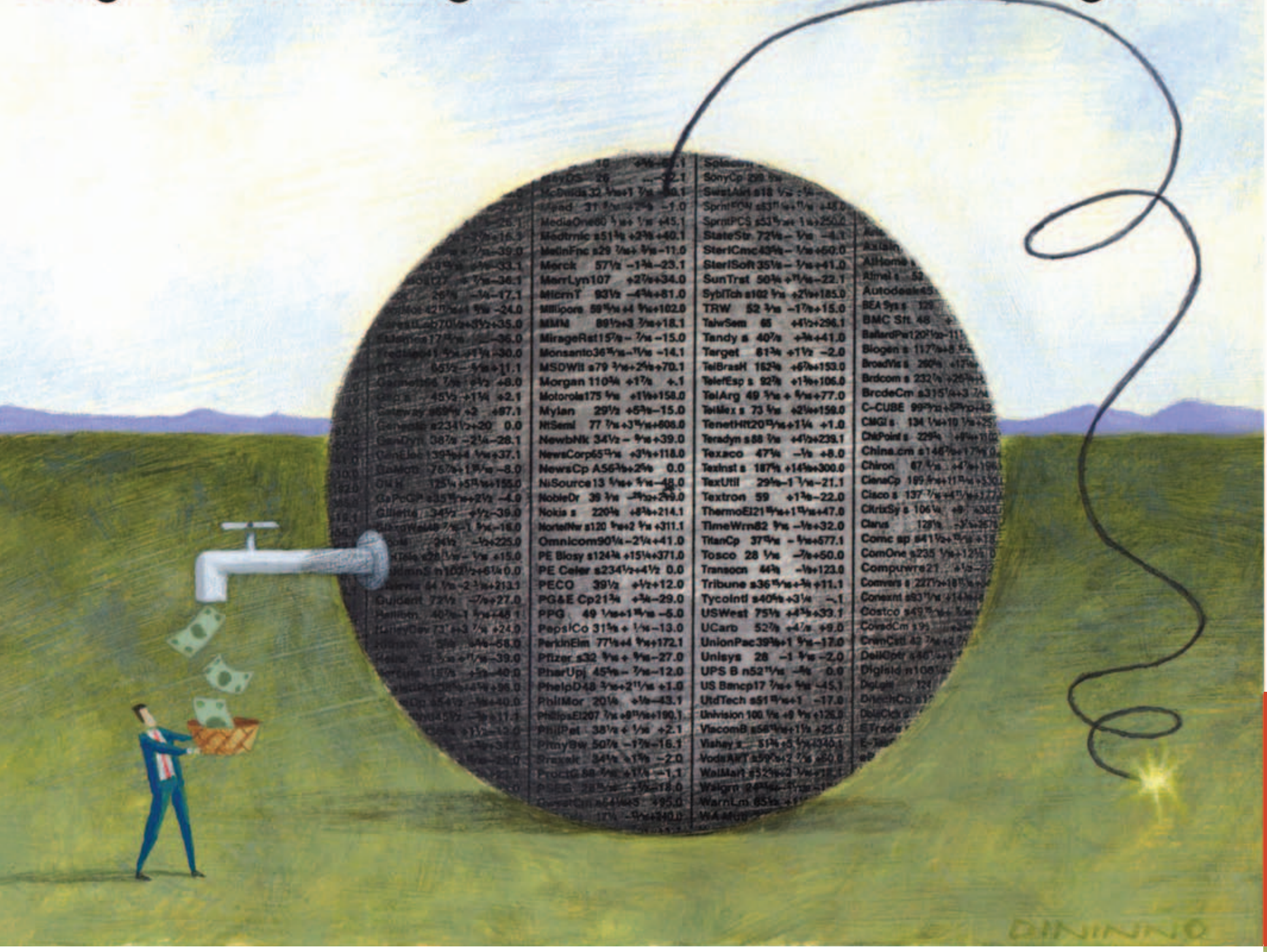
THE SEC'S STATEMENT ON FINANCIAL PENALTIES

Issued in January 2006, the SEC's Statement Concerning Financial Penalties ("Statement") represented a rare illumination of the SEC's enforcement program and its decision-making process concerning when the agency will invoke one of its enforcement tools. (The Statement is available at http://www.sec.gov/news/press/2006-4.htm.) The SEC based its new framework for determining the appropriateness of penalties against a corporation on the penalty statute and its legislative history. As SEC Chairman Christopher Cox noted in a press conference following release of the Statement, "[W]hat we did was go back to first principles. Specifically, to the law, to the authority that Congress gave to the SEC, and to the

continued on page 51

COLLATERAL DAMAGE:

Litigation Involving Collateralized Debt Obligations



By

Jayant W. Tambe

The past few years have seen a surge of investor interest in complex structured investments known as "collateralized debt obligations" ("CDOs"). By some measures, CDOs have attracted more than $1 trillion in investment capital, mostly from institutional and high-net-worth individual investors. This article identifies and discusses some of the principal litigation risks facing CDOs and professional organizations that create, market, manage, and administer CDOs, such as investment banks, securities firms, asset managers, and administrative agents. The article reviews some recent litigation involving CDOs and analyzes novel litigation risks implicated by the sale of CDO securities to high-net-worth individual investors.

CDO BASICS

A CDO is an investment structure of securities whose cash flows are linked to a portfolio of underlying obligations. The underlying obligations may include bank loans, lines of credit, corporate bonds, and various other forms of debt instruments. The cash flows from these various loans and bonds are used to meet the payment obligations of various classes of CDO securities. Using a priority-of-distribution formula, the CDO structure redistributes the credit risk of the underlying portfolio to the different classes of CDO securities. By repackaging and structuring the payment stream from the underlying portfolio of loans and bonds, the CDO structure is able to create customized securities with a range of risk-return profiles that can appeal to a wide range of investors.

The complexity of CDO structures has grown along with their popularity. Addressing all the unique features and risks of the various types of CDO structures is well beyond the scope of this article. Instead, this article focuses on "cash CDOs," in which a special purpose vehicle ("SPV") uses a pool of investment capital to purchase outright a portfolio of corporate debt and loans of varying credit risk and maturity and, against this portfolio, issues two or more tranches of debt securities to the investors. *(See Figure 1.)*

The complexity of CDO structures has grown along with their popularity.

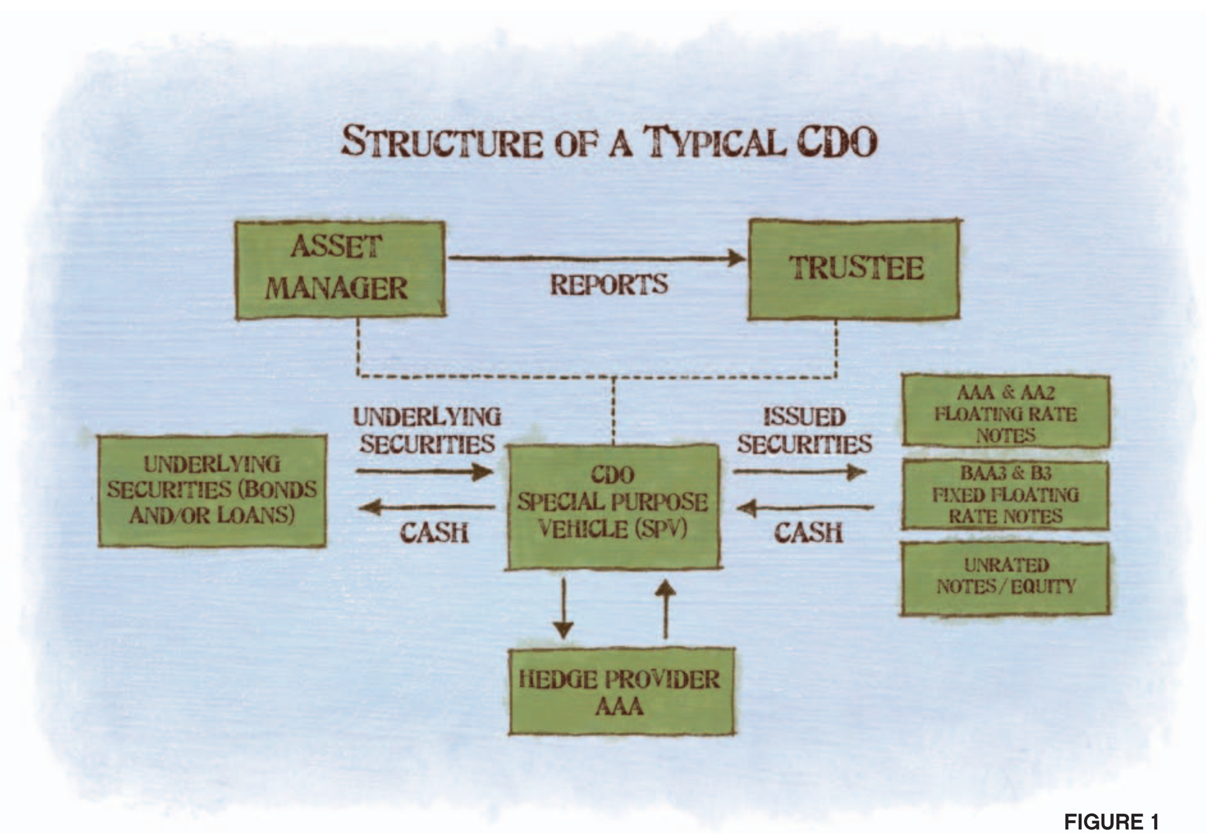


FIGURE 1

The investment pool is managed by a portfolio manager, and the structure is promoted and administered by a bank or securities firm. The SPV is a bankruptcy-remote vehicle and often is organized in a jurisdiction with a favorable regulatory and tax regime. The senior tranche of securities issued by the SPV typically carries an investment-grade credit rating from a rating agency, provides for a fixed rate of return, and is secured by the assets in the investment portfolio. The junior, or subordinated, tranche of securities issued by the SPV is unrated, provides for no fixed rate of return, and is unsecured; however, it offers investors the opportunity of upside returns far in excess of most individual fixed-income debt investments. The subordinated tranche enjoys the prospect of higher potential returns but is more exposed to losses in the investment portfolio. While many CDO structures provide a threshold level of defaults that are absorbed by the sponsor or issuer before the subordinated tranche is financially affected, once that threshold is reached, the brunt of each default is borne entirely by the subordinated tranche.

CDO LITIGATION

To date, there have been few reported cases involving CDOs, and they have been filed almost exclusively by investors who purchased subordinated tranche securities issued by cash CDOs that had been created and marketed in the late 1990s. In the period 2000 through 2002, the corporate debt markets experienced levels of default that were largely unprecedented in the 20th century—indeed, the levels of corporate default experienced in 2000–2002 had been exceeded only twice before: in the Great Depression and in the recession of the early 1990s. *(See Figure 2.)*

Following this period of heightened corporate defaults, junior tranche investors found that not only had their periodic interest payments ceased but, in many instances, their original investment capital had been significantly diminished or entirely lost shortly after these investments were made. These investors, typically small and medium-sized banks and financial institutions, as well as some high-net-worth

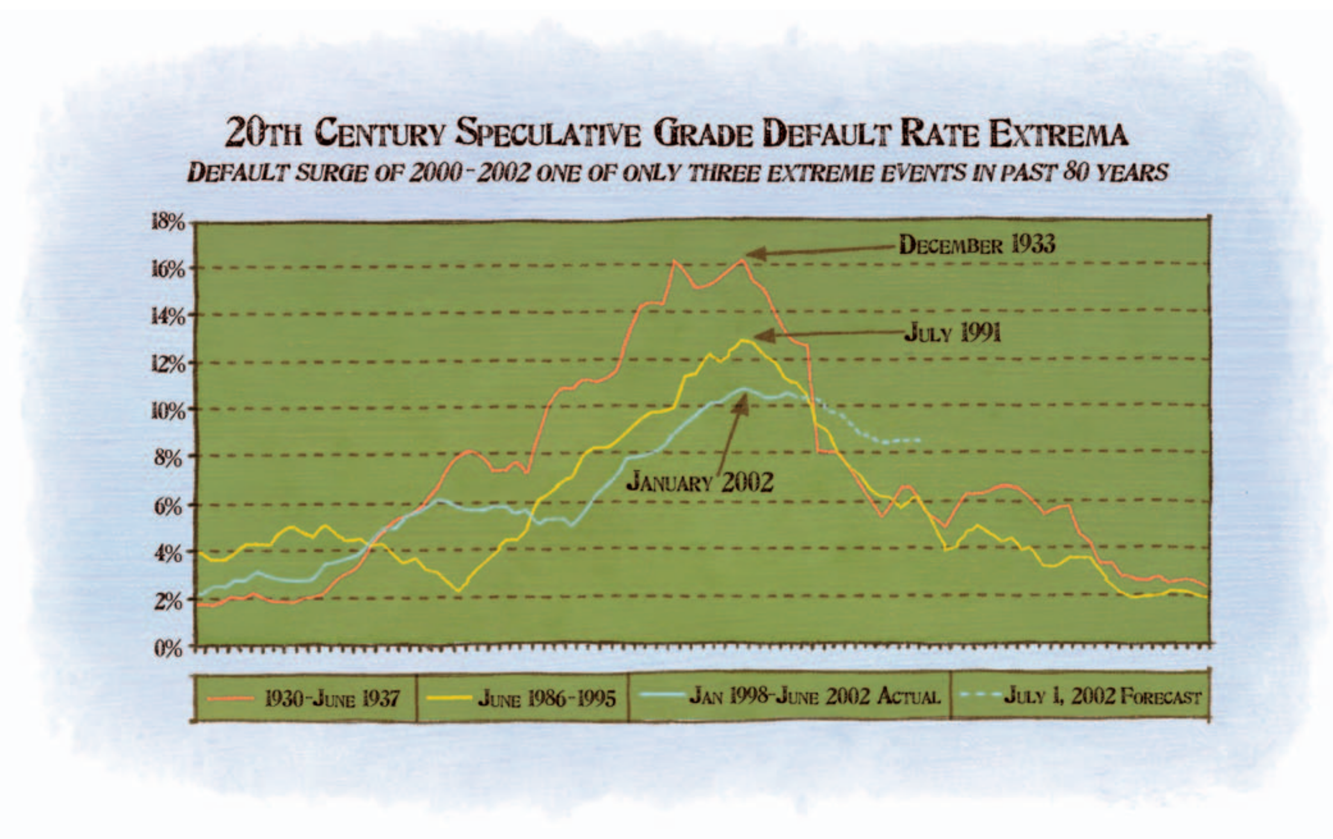


FIGURE 2

individuals, filed claims against (i) the SPVs that had issued the securities, (ii) the investment banks that had sponsored and/or marketed the CDOs, (iii) the portfolio managers and administrative agents of the SPVs, and (iv) in some cases, individual directors and officers of the SPVs. Discussed below are two of these recent cases: *SNS Bank N.V. v. Citibank, N.A.*, filed in New York state court, and *Banco Espirito Santo de Investimento v. Citibank, N.A.*, filed in New York federal court.

SNS Bank N.V. v. Citibank, N.A., et al.

In 1996, SNS Bank, a regional Dutch bank, purchased $15 million in subordinated and unsecured income notes issued by a Cayman Islands CDO fund. The fund invested in primarily United States corporate loans and debt obligations. In 2000–2002, the portfolio suffered significant losses because of multiple corporate defaults across many industries, including airlines, energy, telecommunications, and high technology. In an effort to improve the portfolio's performance, the administrative agent replaced the portfolio manager with an entity that was affiliated with the administrative agent. The portfolio losses nevertheless continued to mount as the market continued to deteriorate.

In 2002, facing a near-total loss of its principal investment, SNS Bank filed suit in New York state court against: (i) the Cayman Islands SPV that had issued the securities, (ii) Citibank, which had served as placement agent for the securities and as administrative agent for the SPV, (iii) the officers and directors of the SPV, and (iv) the individual Citibank officers who had served on the administrative committee of the SPV. SNS Bank alleged a wide range of claims against all of these defendants, including breach of fiduciary duty and breach of the transaction documents and unjust enrichment.

The trial court dismissed all the claims with prejudice, and that dismissal was affirmed on appeal by the New York Appellate Division, First Department. *SNS Bank, N.V. v. Citibank et al.*, 777 N.Y.S.2d 62 (1st Dept. 2004). The outcome in *SNS Bank* is significant to the entire CDO industry because many CDO transactions are governed by New York law and the New York Appellate Division rejected, as a matter of law, the typical claims that are made by disappointed CDO investors. The primary holdings in *SNS Bank* are as follows:

- Ordinarily, the SPV, the SPV's officers and directors, the placement agent, the administrative agent, and its employees owe *no fiduciary duty* to an investor who purchases debt securities from a CDO fund.

- CDO investors have *no third-party beneficiary standing* to seek to enforce contracts between the SPV on the one hand and the administrative agent and the portfolio manager on the other hand.

- Ordinarily, the SPV, the administrative agent, and the portfolio manager have *no general duty to disclose* to the investors any information beyond the obligations specifically undertaken in the transaction documents.

- The *Investment Company Act of 1940 is inapplicable* because the issuer of the securities, the SPV, was not required to be registered under the Act and disclosed that fact in the transaction documents.

Banco Espirito Santo de Investimento v. Citibank

The protections afforded to the CDO industry by the ruling in *SNS Bank* were expanded and bolstered by the district court decision in *Banco Espirito Santo de Investimento ("BESI") v. Citibank*. BESI was an investment bank and part of a substantial financial conglomerate in Portugal. In the late 1990s, it had invested about $25 million in subordinated and unsecured income notes issued by two different Cayman Islands CDO funds. The surge in corporate defaults in 2000–2002 all but wiped out BESI's investment. Like SNS Bank, BESI elected to sue Citibank to recover its investment losses; unlike SNS Bank, BESI did not assert any claims against the SPV, its officers, or any individual employees of Citibank. BESI filed its claims in New York federal court, asserting claims of breach of contract, breach of fiduciary duty, misrepresentation, and unjust enrichment.

While many of BESI's claims were quite similar to those asserted by SNS Bank, there was one theory of liability that was quite distinct. BESI attempted to impose obligations upon Citibank beyond those imposed by the transaction documents by alleging that Citibank had made a series of

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WHEN SECONDARY

IS PRIMARY

By Robert C. Micheletto
and S. Joseph Hand

SCHEME LIABILITY UNDER RULE 10b-5(a) AND (c)

In *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 191 (1994), the Supreme Court ruled that secondary actors such as banks, auditors, and law firms could not be liable under Section 10(b) of the Securities Exchange Act of 1934 or SEC Rule 10b-5 for aiding and abetting securities fraud. In so ruling, however, the Court did not completely absolve secondary actors from liability under the securities laws. *Central Bank* specifically noted that:

> [a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met.

Id. Plaintiffs in the post-*Central Bank* era have argued under subsections (a) and (c) of Rule 10b-5 (also known as the "scheme liability" subsections) that secondary actors should be held liable as primary violators. Generally, in 10b-5(a) and (c) cases, plaintiffs allege that secondary actors entered into fraudulent transactions (such as creating worthless invoices, participating in wash transactions with no economic substance, or financing sham entities) with the primary actor(s). The plaintiffs do not allege that the secondary actors made or participated in the making of a material misstatement or omission (*i.e.*, 10b-5(b) type of activity).

Two separate tests have emerged to determine what type of activity constitutes a primary violation of the securities laws in 10b-5(a) and (c) cases. Recently, the Supreme Court granted *certiorari* to hear a case out of the Eighth Circuit, under the caption *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc., et. al*. *See Stoneridge Investment Partners LLC v. Scientific-Atlanta*, ___ S. Ct. ___, 2007 WL 879583 (2007) (Chief Justice Roberts and Justice Breyer took no part in the decision). The case below was *In re Charter Communications, Inc. Securities Litigation*, 443 F.3d 987 (8th Cir. 2006). The Court accepted the question presented as:

> Whether this Court's decision in *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994), forecloses claims for deceptive conduct under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5(a) and (c), 17 C.F.R. 240.10b-5(a) and (c), where Respondents engaged in transactions with a public corporation with no legitimate business or economic purpose except to inflate artificially the public corporation's financial statements, but where Respondents themselves made no public statements concerning those transactions.

See Supreme Court Docket No. 06-43, http://www.supremecourtus.gov/qp/06-00043qp.pdf (last visited May 17, 2007). The Supreme Court has scheduled the case for the October 2007 term but as of publication had not yet set a date for oral argument. *See* Supreme Court of the United States, Granted & Noted Cases List for Argument—October Term 2007, http://www.supremecourtus.gov/orders/07grantednotedlist.html (last visited May 17, 2007).

This article examines the two tests employed by the federal circuit courts to determine whether a secondary actor is liable as a primary violator and outlines the circuit split, which the Supreme Court has targeted.

SECTION 10(b) AND RULE 10b-5

Section 10(b) of the Exchange Act provides that:

> It shall be unlawful for any person, directly or indirectly . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C.A. § 78j(b) (West 2006).

Rule 10b-5 states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2006).

The substantial-participation test and the bright-line test are the two competing tests used by the circuit courts in determining the primary liability of secondary actors in 10b-5(a) and (c) cases.

The substantial-participation test requires secondary actors to substantially participate or be intricately involved in the preparation of fraudulent statements to be liable under Section 10(b) and Rule 10b-5; the bright-line test requires secondary actors to "actually make a false or misleading statement" to be liable. The Fifth, Eighth, and Ninth Circuits have taken 10b-5(a) and (c) cases. The Ninth Circuit applies the substantial-participation test, while the Fifth and Eighth apply the bright-line test. As noted above, the Supreme Court has granted *certiorari* to hear the Eighth Circuit case.

This article examines **the two tests** employed by the federal circuit courts to determine whether a secondary actor is liable as a primary violator and outlines the circuit split, which the Supreme Court has targeted.

THE SUBSTANTIAL-PARTICIPATION TEST

The substantial-participation test predates *Central Bank* but has been applied post-*Central Bank*. Under the substantial-participation test, secondary actors can be held primarily liable when they substantially participate or are intricately involved in the preparation of fraudulent statements, even though the secondary actor's participation might not lead to the primary actor actually making the statements. *See Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000); *see also In re Software Toolworks*, 50 F.3d 615, 628–629 (9th Cir. 1994) (finding accountant to be a primary violator for playing a significant role in drafting and editing two letters to the SEC that contained false information).

In *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040, 1046–50 (9th Cir. 2006), a 10b-5(a) and (c) case, the Ninth Circuit distinguished between the application of the substantial-participation test in 10b-5(a) and (c) cases and 10b-5(b) cases. Specifically, secondary actors in 10b-5(a) and (c) cases are not liable for mere participation in a scheme to defraud. *Id.* To be liable as a primary violator of Section 10(b) in (a) and (c) cases, a secondary actor must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in the furtherance of a scheme to defraud. *Id.* This "principal purpose and effect" requirement is an attempt by the Ninth Circuit to use the substantial-participation test to capture primary violators of Section 10(b) without overreaching into the prohibited realm of aiding and abetting. The Ninth Circuit "see[s] no justification to limit liability under § 10(b) to only those who draft or edit the statements released to the public." *Simpson*, 452 F.3d at 1049.

THE BRIGHT-LINE TEST

The bright-line test requires that a party must "actually make a false or misleading statement" for a Section 10(b) violation; "anything short is aiding and abetting." *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 499 (S.D.N.Y. 2005). The Fifth and Eighth Circuits have applied the bright-line test to situations where plaintiffs alleged violations of 10b-5(a) and (c). *See Regents of the Univ. of California v. Credit Suisse First Boston (USA), Inc. et al.*, No. 06-20856, 2007 WL 816518, *___ (5th Cir. March 19, 2007) (noting that a finding of liability under § 10(b) "involves either a misstatement or a failure to disclose by one who has a duty to disclose"); *In re Charter Communications, Inc. Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006), *cert. granted sub nom. Stoneridge Investment Partners LLC v. Scientific-Atlanta*, ___ S. Ct. ___, 2007 WL 879583 (2007) (court in a scheme liability case held that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5").

The Eighth Circuit claimed it was adhering to the principles of *Central Bank* in evaluating a scheme liability claim, noting that a device or contrivance is not deceptive absent a misstatement or omission by one who has a duty to disclose. The Eighth Circuit stated that the terms "deceptive" and "manipulative" have narrow meanings and limited suits brought by private plaintiffs to conduct expressly prohibited by the text of Section 10(b). The Fifth Circuit followed the Eighth Circuit's lead, and its holding in *Regents of the Univ. of California* is squarely in accord with that of the Eighth Circuit in *Charter Communications*. In *Regents of the Univ. of California*, plaintiffs alleged that the banks allowed Enron to misstate its financial conditions. The Fifth Circuit found plaintiffs' allegations insufficient, noting that "[p]resuming plaintiffs' allegations to be true, Enron committed fraud by misstating its accounts, but the banks only aided and abetted that fraud by engaging in transactions to make it more plausible; they owed no duty to Enron's shareholders." The Fifth Circuit opted

continued on page 47

What Does It Take to Satisfy the Government?

Recent Developments Regarding Corporate Cooperation in Government Investigations

By Harold K. Gordon

Federal prosecutors and regulators have significant leverage over public companies to induce cooperation in government investigations. As the demise of the international accounting firm Arthur Andersen confirmed for many, the government's filing of criminal charges against a company can frequently portend its end, regardless of whether it eventually prevails in court, as Arthur Andersen did on appeal. *Arthur Andersen LLP v. U.S.*, 544 U.S. 696, 708 (2005). The same result can occur from civil or administrative law enforcement proceedings by the Securities and Exchange Commission ("SEC") or other law enforcement or regulatory agencies. A company's stock price typically falls after a government action, sometimes followed by its credit rating. Key members of management may depart or be forced out, and important customers and vendors may disappear. Adding to the proverbial piling-on, an indictment or civil government action is likely to attract the attention of other regulators or law enforcement agencies and the plaintiffs' securities bar. Given the collateral consequences of a government action, responsible management and board members must consider the merits of cooperating in the hope of either avoiding an action altogether or negotiating a resolution on more acceptable charges or claims.

In a series of memoranda stretching back to 1999, the Department of Justice ("DOJ") has described the factors federal prosecutors around the country must consider in determining whether to indict corporations for criminal misconduct. One of the factors is the extent of the corporation's cooperation in the government's investigation. Until the DOJ's most recent memorandum on the subject, issued by Deputy Attorney General Paul J. McNulty on December 12, 2006 (the "McNulty Memo"), one element of cooperation was, if a prosecutor deemed it necessary, waiver of the corporation's protections under the attorney-client privilege and the work-product doctrine. Prior to the McNulty Memo, prosecutors also had to consider the extent to which a corporation under investigation appeared to be protecting employees involved in apparent misconduct by, among other things, advancing their attorneys' fees.

By limiting when and how prosecutors can request that a corporation waive its attorney-client or work-product protections, and when they can consider a corporation's advancement of attorneys' fees to its employees, the McNulty Memo endeavors to respond to the criticisms of multiple bar groups, adverse court decisions, and Congress. The concerns were that the DOJ's practice of seeking privileged and work-product protected information had become too pervasive and routine, and that its questioning of corporate practices regarding payment of attorneys' fees had, in certain instances, caused a violation of the constitutional rights of corporate officers and employees under investigation who were left without the funds to pay for counsel.

Though the DOJ should be commended for at least responding to these concerns, reaction to the McNulty Memo remains mixed. Corporate defense counsel now fear that government waiver requests that were previously made expressly will now simply be conveyed more subtly, or that corporations desperate to appease line-level prosecutors will simply volunteer protected information, given that the McNulty Memo still permits prosecutors to credit corporate targets for providing such information and that they are not required to seek approval from senior DOJ officials where a corporation voluntarily offers it.

Like the DOJ, regulatory agencies that govern and police the financial services industry and the stock exchanges, such as the SEC, the Commodity Futures Trading Commission ("CFTC"), and the New York Stock Exchange ("NYSE"), have issued their own criteria to gauge corporate cooperation. Pressure is now being brought to bear on the SEC to amend its statement on cooperation to delete language that the defense bar claims has played a role in the "culture of waiver" of corporate privileges that initially led the DOJ to issue the McNulty Memo.

THE ORIGINS OF CORPORATE CRIMINAL LIABILITY

Under English common law, corporations could not be found liable for criminal misconduct. In the United States, statutes and case law have long held that criminal liability can apply to corporations.*[1] Corporations are "legal persons" that can engage in criminal conduct and be sued. Pursuant to the doctrine of *respondeat superior,* a corporation can be sued and held criminally liable for the illegal acts of its directors, officers, employees, and agents acting within the scope of their responsibilities with the intent to benefit the corporation. Even if a corporate agent acts for selfish reasons, the corporation can be held criminally liable as long as one motivation of the agent was to benefit the corporation. *E.g.*, *U.S. v. Potter*, 463 F.3d 9, 25 (1st Cir. 2006) (quoting *U.S. v. Cincotta*, 689 F.2d 238, 241–42 (1st Cir. 1982)). A corporation need not actually benefit from its employee's actions to be exposed to criminal liability. *E.g.*, *U.S. v. Automated Med. Labs., Inc.*, 770 F.2d 399, 407 (4th Cir. 1985).

A CORPORATION'S ATTORNEY-CLIENT PRIVILEGE AND WORK-PRODUCT PROTECTION

The attorney-client privilege protects client communications with an attorney made for the purpose of obtaining legal advice. *E.g.*, *Fisher v. U.S.*, 425 U.S. 391, 403 (1976). The policy behind the privilege is to encourage "full and frank communication between attorneys and their clients and thereby

* *Endnotes for this story appear on pages 50 and 51.*

promote broader public interests in the observance of law and the administration of justice." *E.g.*, *Swidler & Berlin v. U.S.*, 524 U.S. 399, 403 (1998) (quoting *Upjohn Co. v. U.S.*, 449 U.S. 383, 389 (1981)). Corporations are legal entities entitled to the attorney-client privilege, which applies in the corporate setting to confidential communications from corporate officers, agents, and employees to the corporation's attorney so that the attorney can render legal advice to his or her corporate client. *E.g.*, *Upjohn Co.*, 449 U.S. at 390–98.

"Attorney work product" refers to documents gathered, selected, or created that reveal an attorney's thought process in preparing his or her client's case for current or likely litigation. *E.g.*, *Hickman v. Taylor*, 329 U.S. 495, 511 (1947). This additional protection from disclosure applies in criminal and civil cases. Fed. R. Crim. P. 16; *U.S. v. Nobles*, 422 U.S. 225, 236–39 (1975).

DOJ MEMORANDA ON CHARGING CORPORATIONS AND CORPORATE COOPERATION

The DOJ has issued at least four memoranda discussing the factors federal prosecutors must weigh in assessing a corporation's cooperation and determining whether criminal charges against a corporation are warranted. Preceding the McNulty Memo were the Holder Memo, the Thompson Memo, and the McCallum Memo.

The Holder Memo was issued in 1999 by Deputy Attorney General Eric H. Holder, Jr., and was intended to give prosecutors guidelines to follow in deciding whether to criminally charge a corporation.[2] Regarding cooperation and disclosure of protected material, the Holder Memo stated that in measuring a corporation's cooperation, a prosecutor could consider whether the corporation was willing to waive its attorney-client privilege and work-product protection on the results of a corporate internal investigation and communications between corporate officers, directors, and employees and the corporation's attorneys. It also recommended that prosecutors consider the extent to which a corporation appeared to be shielding personnel involved in the conduct under investigation by paying their attorneys' fees, sharing information with their counsel pursuant to joint defense agreements, or failing to sufficiently sanction them.

Issued in January 2003 by Deputy Attorney General Larry D. Thompson, the Thompson Memo escalated the scrutiny prosecutors were required to give corporate cooperation by taking the guidance of the Holder Memo and making it mandatory. Whereas the Holder Memo prefaced its suggested factors with the statement that they were "not outcome-determinative and are only guidelines[, which] . . . Federal prosecutors are not required to reference . . . in a particular case,"[3] the Thompson Memo directed that "prosecutors and investigators in every matter involving business crimes must assess the merits of seeking the conviction of the business entity itself."[4] The Thompson Memo was issued against the backdrop of the highly publicized allegations of systemic misconduct at corporations like Enron, WorldCom, and Tyco International and the Executive and congressional response to those accounting and financial reporting scandals, including the enactment of the Sarbanes-Oxley Act on July 25, 2002, and President Bush's Executive Order issued the same month directing Deputy Attorney General Thompson to establish a Corporate Fraud Task Force (Exec. Order No. 13271, 67 Fed. Reg. 46091 (July 9, 2002)).

The Thompson Memo added as an additional factor the requirement that prosecutors determine the sincerity of a corporation's cooperation:

> Another factor to be weighed by the prosecutor is whether the corporation, while purporting to cooperate, has engaged in conduct that impedes the investigation (whether or not rising to the level of criminal obstruction). Examples of such conduct include: overly broad assertions of corporate representation of employees or former employees; inappropriate directions to employees or their counsel, such as directions not to cooperate openly and fully with the investigation including, for example, the direction to decline to be interviewed; making presentations or submissions that contain misleading assertions or omissions; incomplete or delayed production of records; and failure to promptly disclose illegal conduct known to the corporation.[5]

Confirming this additional mandate, the Thompson Memo emphasized that the main purpose of its revisions to the Holder Memo was an "increased emphasis on and scrutiny of the authenticity of a corporation's cooperation. Too often business organizations, while purporting to cooperate with a . . . [DOJ] investigation, in fact take steps to impede the quick and effective exposure of the complete scope of wrongdoing under investigation. The revisions make clear that such conduct should weigh in favor of a corporate prosecution."[6]

The Holder and Thompson Memos were followed in October 2005 by the McCallum Memo, issued by Acting Deputy Attorney General Robert D. McCallum, Jr. Making no revisions to the Thompson Memo, the McCallum Memo took an initial step to at least impose some order and consistency on the manner in which federal prosecutors requested and considered a corporation's waiver of its attorney-client and work-product protections. It required the DOJ, including the various U.S. Attorneys' Offices around the country, to prepare and implement written procedures for prosecutors to obtain approval from their supervisors to request corporate waivers.[7]

The Thompson Memo added as an additional factor the requirement that prosecutors determine the sincerity of a corporation's cooperation.

ORGANIZATIONAL SENTENCING GUIDELINES REINFORCING THE THOMPSON MEMO

With amendments that some attorneys read as reinforcing the Thompson Memo, in 2004 the United States Sentencing Commission ("the Sentencing Commission") revised the Commentary to its organizational sentencing guidelines to state that an organization's waiver of its attorney-client or work-product protections could affect the organization's sentencing or culpability score under the guidelines:

> Waiver of attorney-client privilege and of work product protections is not a prerequisite to a reduction in culpability score under subdivisions (1) and (2) of subsection (g) unless such waiver is necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization.[8]

Following objections by the American Bar Association ("ABA") and the defense bar, in April 2006 the Sentencing Commission unanimously voted to delete the waiver comment in the guidelines. The change became effective in November 2006.

THE McNULTY MEMO

The DOJ's December 2006 McNulty Memo was a response to criticism of the DOJ's conduct in implementing the Thompson Memo. The criticism emanated from all corners of the legal profession. Surveying counsel on the impact of the DOJ's cooperation policies, the Association of Corporate Counsel reported in April 2005 that a substantial percentage of the corporate counsel surveyed agreed that a government culture seeking waivers existed, and that in their view, the government treated waiver as a condition of cooperation.[9] In August 2006, the ABA issued a resolution opposing the government's consideration of a number of the Thompson Memo factors, including whether the company provided counsel to its employees in the investigation, paid employees' legal fees, shared information or documents with current or former employees pursuant to joint defense agreements, or failed to sanction an employee for exercising his legal rights not to cooperate with a government investigation.[10] An earlier ABA Task Force Report emphasized that corporations could not practically refuse to waive their legal protections to demonstrate cooperation because of the significant harm that would occur from criminal charges; that government pressure to cooperate could cause companies to make premature determinations about employee culpability before the facts have been fully determined; and that the government's conduct in seeking cooperation had "unintentionally undermined corporate compliance with the law" by making employees hesitant to speak with or seek the advice of company counsel, knowing there was a good chance the results of their conversations would be provided to government attorneys.[11]

On the legislative front, the same concerns were voiced by former Attorneys General and others in hearings conducted during the 109th Congress by the House and Senate Judiciary Committees. In December 2006, Senator Arlen Specter (R-PA) introduced proposed legislation, the Attorney-Client Privilege Protection Act of 2006, which would have amended the federal criminal code to prohibit the DOJ or other federal law enforcement authorities from seeking waivers of corporate attorney-client or work-product protections, or basing a decision to charge a corporation on the corporation's refusal to waive or on the payment of attorneys' fees for corporate officers or employees. S. 30, 109th Cong. (2006). Senator Specter reintroduced the same proposed legislation in January 2007. The 2007 bill permits the government to request information it believes is not covered by the attorney-client privilege or protected as attorney work product, and would not preclude a company from voluntarily sharing such material with the government. S. 186, 110th Cong. (2007), http://acc.com/public/attyclientpriv/thompsonmemoleg.pdf.

Pressure for revisiting the Thompson Memo also arose in the courts. In 2006, a Manhattan federal district judge determined that the DOJ's use of the Thompson Memo to force accounting firm KPMG to terminate payment of legal fees for certain employees who refused to cooperate in the government's criminal tax investigation violated the employees' Fifth Amendment substantive due-process rights, along with their privilege against self-incrimination and their Sixth Amendment right to the assistance of counsel. *U.S. v. Stein*, 435 F. Supp. 2d 330, 381–82 (S.D.N.Y. 2006). In a subsequent decision, the same judge suppressed certain employee statements, finding that the government's conduct in forcing KPMG to pressure employees to cooperate or risk termination of their jobs or further payment of their lawyers had improperly coerced the statements. *U.S. v. Stein*, 440 F. Supp. 2d 315, 337–38 (S.D.N.Y. 2006).

In addition, the courts have yet to settle the quandary confronting many corporations deciding whether to waive legal protections to cooperate with the government, which is the risk that by selectively waiving those protections and producing protected material to the government, a corporation will be deemed to have waived its privileges and protections with regard to everyone else, including plaintiffs seeking the same information in private securities or derivative litigation against the company. A number of courts have held that a corporation's selective production of privileged or work-product protected material to the government triggers a waiver in favor of third parties.[12]

Efforts to amend the Federal Rules of Evidence to provide corporations involved in government investigations with selective waiver protection are in doubt. Proposed Federal Rule of Evidence 502(c) would provide that a corporation's disclosure of privileged or work-product protected information to a

federal office or agency pursuant to the government's regulatory, investigative, or law enforcement authority would not trigger a waiver of those protections in favor of nongovernmental individuals or entities. Objections to the proposed rule from plaintiffs and defense attorneys and the government appear likely to block its approval.[13]

Responding to the growing criticisms of the DOJ's practices under the Thompson Memo, the McNulty Memo, issued on December 12, 2006, less than a week after Senator Specter introduced his proposed Attorney-Client Privilege Protection Act, supersedes the Thompson Memo and the McCallum Memo.[14] In his covering memorandum accompanying the McNulty Memo, Deputy Attorney General McNulty stated:

> We have heard from responsible corporate officials recently about the challenges they face in discharging their duties to the corporation while responding in a meaningful way to a government investigation. Many of those associated with the corporate legal community have expressed concern that our practices may be discouraging full and candid communications between corporate employees and legal counsel.[15]

The McNulty Memo states that a corporation's waiver of the attorney-client and work-product protections is not a prerequisite to determining that the corporation has provided the government with sufficient cooperation, although it adds that a company's disclosure of protected material may assist the government in expediting an investigation and in evaluating the accuracy and completeness of the company's other voluntary disclosure.

Under the McNulty Memo, prosecutors may request a waiver of privileged or protected material only if there is a "legitimate need" for it. Factors in determining whether a legitimate need exists include: (i) the likelihood and degree to which the privileged information will benefit the government's investigation; (ii) whether there are alternative means to obtain the same information; (iii) the completeness of the voluntary disclosure already provided; and (iv) the collateral consequences to a corporation from waiver.

The DOJ's December 2006 McNulty Memo was a response to criticism of the DOJ's conduct in implementing the Thompson Memo. The criticism emanated from all corners of the legal profession.

If a legitimate need exists, prosecutors are instructed under the McNulty Memo to first seek factual information, which may or may not be privileged; this is referred to as "Category I" material. Category I material includes such documents as witness statements, "purely factual interview memoranda," and organizational charts and chronologies created by counsel. Prior to requesting a corporation to waive privileges or protections for Category I information, prosecutors must first obtain written authorization from their United States Attorney, who must then provide a copy of the request to, and confer with, the Assistant Attorney General for the DOJ's Criminal Division before the request is granted or denied. A corporation's response to the government's request for Category I material may be considered in determining whether a corporation has cooperated in the government's investigation.

Only if Category I information, to the extent required, still leaves the government with an incomplete investigation are prosecutors authorized to seek what the McNulty Memo refers to as "Category II" material, which includes notes, memoranda, or other documentation reflecting the advice, impressions, and conclusions of a corporation's attorneys. The McNulty Memo cautions that Category II information may be sought only in "rare circumstances." A request for Category II information first requires that the appropriate United States Attorney obtain written authorization from the Deputy Attorney General. The McNulty Memo states that a prosecutor must not consider a corporation's decision to decline to provide a waiver of Category II information in determining whether to bring criminal charges against the corporation. It does provide, however, that prosecutors may always favorably consider a corporation's agreement to waive privileges in assessing cooperation, and that prosecutors need not obtain the authorization of their supervisors if a corporation voluntarily offers privileged or protected material without a waiver request.

Addressing the criticism of the DOJ's scrutiny of corporations advancing attorneys' fees to employees, the McNulty Memo states that prosecutors should not generally take that into consideration, regardless of whether an employee is under investigation or indictment, especially since many corporations contractually agree, pursuant to state indemnification statutes, to advance attorneys' fees to officers and employees through provisions in their corporate charters, bylaws, or employment agreements. It provides that in "extremely rare cases," prosecutors may, with the approval of the Deputy Attorney General, consider a corporation's payment of attorneys' fees for officers or employees when the totality of the circumstances indicates such payments were intended to impede the government's investigation.

In recent remarks, Deputy Attorney General McNulty said that Senator Specter's proposed Attorney-Client Privilege Protection Act was unnecessary. He pointed to DOJ statistics indicating that since the DOJ issued the McNulty Memo in December 2006, his office had not received a single request for Category II privileged information and had received only five requests to approve waiver of Category I factual information.[16]

REMAINING CONCERNS

Deciding whether a corporation should waive its protections from disclosure and cooperate with the DOJ or a government law enforcement agency is necessarily a fact-specific analysis. There will be instances where cooperation to the extent of producing protected material should help avoid or reduce potential charges or claims by further demonstrating that a corporation is a good corporate citizen and has followed through on its promise to cooperate. In other situations, an investigation may involve a government regulator with which a corporation interacts frequently in its industry and will continue to do so for the foreseeable future. In some cases, the risk of a selective waiver in the government's favor will be minimized because the company will have resolved related private securities or other litigation against it or because the statute of limitations on such litigation will have run.

For corporations enmeshed in DOJ investigations, it remains far from clear that the McNulty Memo reduced the pressure to evidence cooperation by providing protected material or by refusing to pay an employee's attorneys' fees. Part of the problem stems from the vagueness of some of the McNulty Memo's standards and procedures. For instance, what constitutes a "legitimate need" by a prosecutor for protected information is still unclear, and the fact that the "completeness of the voluntary disclosure already provided" is listed as one of the criteria for determining when a legitimate need exists will be interpreted by some corporations to mean that if protected material is not voluntarily produced to the prosecutor, which the prosecutor is entitled to accept and credit on the cooperation ledger without approval, a waiver may be sought. What differentiates Category I material from Category II material is also far from clear. It is easy to imagine how the "key documents," witness statements, and attorney charts or chronologies labeled "Category I material" could readily reveal corporate counsel's thought process, conclusions, and impressions—that is, information falling in Category II.

Further, the fact that the McNulty Memo states that disclosure of protected information may "permit the government to expedite its investigation" and "may be critical in enabling the government to evaluate the accuracy and completeness of the company's voluntary disclosure," while indicating that the government may still consider it in measuring a corporation's cooperation, has raised a concern among some corporate defense attorneys that all the McNulty Memo will do is convert the prior Thompson Memo waiver request practice into a subtle "don't ask, don't tell" policy or "unspoken wink and nod" process where an aggressive prosecutor makes it abundantly clear without asking that sufficient cooperation will entail a voluntary privilege waiver.[17]

The same subtle pressure may be brought to bear under the McNulty Memo on the subject of a corporation's payment of an officer's or employee's attorneys' fees. It provides that although prosecutors generally should not take such payments into account, they are still free to ask questions about the subject.

COOPERATION STATEMENTS BY FINANCIAL REGULATORS

The SEC, CFTC, and NYSE have each issued their own statements regarding cooperation in agency and stock exchange investigations.[18] The CFTC recently amended its 2004 Enforcement Advisory on Cooperation specifically to clarify that the considerations in that advisory are designed to encourage cooperation among individuals or entities involved in CFTC enforcement investigations "without eroding the protections of the attorney-client or work product privileges."[19] Pressure is now being put on the SEC to make similar changes to its principles governing cooperation.

The SEC's statement on cooperation, known as the "Seaboard Report," lists 13 factors the SEC will consider in determining the amount of credit to be given for "self-policing, self-reporting, remediation and cooperation—from the extraordinary step of taking no enforcement action to bringing reduced charges, seeking lighter sanctions, or including mitigating language in documents [the SEC] use[s] to announce and resolve enforcement actions."[20] In January 2006, the SEC reiterated the importance with which it regards cooperation in its investigations by including the extent of a corporation's cooperation, including the degree to which it self-reported an offense or otherwise cooperated with the investigation and remediation of the offense, in a statement discussing the factors it will consider in determining whether to seek a financial penalty against a corporation.[21] (For a related article on the SEC's penalties statement, see page 24 of this publication.)

With language that evokes the Thompson Memo, the 11th factor in the SEC's Seaboard Report examines whether a company promptly provided the SEC Staff ("Staff") with the results of an internal investigation and the company's response, including "a thorough and probing written report detailing the findings of its review."[22] It further reviews whether a company voluntarily disclosed information the Staff did not request, asked its employees to cooperate with the Staff, and made "all reasonable efforts" to obtain such cooperation. In a footnote, the SEC stated that in certain cases, a company may choose to waive its attorney-client privilege and work-product protections to provide information to the Staff.[23]

In a recent speech, SEC Commissioner Paul S. Atkins noted that although the Seaboard Report did not include waiver as a factor to be considered in evaluating cooperation, the practice of corporate waivers "creeps in" through that footnote. He stated that "[i]n the six years since Seaboard was issued, this footnote has become the backdoor through which credit has been afforded for waiver," and he recommended that the SEC consider the McNulty Memo approach by requiring all formal Staff waiver requests to be reviewed at the "highest levels" at the SEC and to be subject to specific policies and procedures.[24] In a letter sent four days before Commissioner Atkins' speech, ABA President Karen J. Mathis asked SEC Chairman Christopher Cox to amend the Seaboard Report to end the Staff's practice of requiring companies to waive privileges or protections to receive Staff credit for cooperation. Her letter contained an edited version of the Seaboard Report with the ABA's desired changes.[25]

CONCLUSION

The widespread criticisms of the DOJ's practices regarding corporate cooperation preceding the McNulty Memo and certain statements in the memorandum may in some cases provide additional ammunition to corporations that choose to preserve their privileges and protections. The cooperation credit that remains, however, for voluntary production of protected material leaves corporations with cause for concern that the McNulty Memo's changes may be form over substance in the day-to-day interactions their attorneys have with line-level prosecutors, given the immense pressure on corporations to evidence sufficient cooperation with the government. Until the SEC makes changes in the language of its Seaboard Report like those the ABA has recently proposed, corporate counsel involved in SEC investigations should expect to continue to confront the merits of waiving their clients' privileges and protections, as well as questions regarding advancement of attorneys' fees for corporate personnel, in struggling to garner sufficient cooperation points with the SEC Staff. ■

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informal—will be beneficial. Just as consolidation runs the risk of allowing coordination among plaintiffs' counsel, a joint defense arrangement will permit parties to share the defense load, including, as to briefing, fact development, discovery, and trial preparation.

Discovery. The discovery process—in the context of litigation or governmental investigations—presents dangers in any litigation, heightening the necessity for careful preparation. Broad-based, simultaneous discovery, often found in the current era of securities disputes, presents great opportunities but significant challenges. The opportunities and challenges only increase where related matters have been initiated.

Document Productions. Defendants should consider whether to keep document productions separate for each matter. Even if productions are separated, to the extent possible (this will obviously be driven by the document requests), the goal should be to produce the same documents, using the same document-management system, to each claimant.

A similar consideration is whether to resist document- and deposition-sharing arrangements among plaintiffs' counsel in each matter. The cost of reproducing documents or producing witnesses a second time may be less than the value claimants may derive from a cooperative effort. Another consideration is whether defendants will realistically be able to prevent sharing among counsel or producing the materials to all of the counsel. Defendants should normally seek to avoid putting themselves and their witnesses in the position where a single deponent will face multiple depositions by plaintiffs' counsel who are progressively more educated. Providing plaintiffs with multiple "bites at the apple" in this manner presents a significant risk.

Privilege. Privilege decisions take on added importance in the situation where privileged materials could be harmful on numerous case fronts. The most damaging documents may be cloaked in a proper privilege; defense counsel should ordinarily be diligent in protecting any privilege and avoid waiver of the privilege. Governmental investigatory bodies (*e.g.*, the SEC) may be quite persuasive in attempting to secure a voluntary production of privileged documents. Although there is support (including recent authority) for the notion of a limited waiver of privilege in certain circumstances, counsel must approach waiver decisions with the expectation that a disclosure of privileged material to the government may be argued to effectively result in a total waiver.

Disclosure to auditors and other investigators of privileged documents, especially if used in a published report, may similarly be argued to constitute a waiver as to claimants. This issue may take on added significance in situations where potential accounting irregularities are in question and auditors threaten to hold an audit report until privileged or work-product protected materials are produced and analyzed. Care and planning must also be given to communicating with insurers regarding the status and risks of defense without waiving applicable privileges.

Settlement Considerations. Proceeding with numerous related actions also implicates a number of settlement considerations. While a global settlement is always desirable, it may not always be possible.

First, the various matters may not all be in a procedural posture that facilitates a coordinated settlement. For example, to the extent that derivative actions have been stayed during the pendency of a securities action, it may be more difficult to reach a settlement of those actions quickly should a settlement of the underlying securities action be brokered. Insurers may object to or refuse to tender policy proceeds toward a settlement that does not resolve all of the claims that have been noticed against the policies.

Second, the existence of insurance policies that are expected to contribute to any settlement creates an additional complication from the perspective of seeking a global settlement (or keeping open the possibility of seeking such a settlement). Depending on how the company's insurance tower is structured, there may be multiple towers implicated by the various matters. For example, an ERISA action may fall within one tower, while securities/derivative actions may trigger another tower. Additionally, within a tower that applies to securities and shareholder derivative actions, certain layers may respond to both types of actions, while upper layers may limit coverage (so-called "Side A only" insurance, which might respond to derivative but generally not securities claims).

Third, both class and derivative litigation settlements generally require court approval. Counsel should consider whether presenting a global settlement of the various related actions may make it easier to obtain approval. For example, a court may be more inclined to approve a shareholder derivative settlement if the settlement is part of a global settlement in which related claims against the company are resolved and the company's shareholders receive a significant benefit.

Finally, the timing of a civil litigation settlement may be influenced by the existence of governmental investigations. Because an investigation may be the first to reach final conclusion on the merits, counsel should consider the impact of a potentially adverse agency determination or action on the settlement (and/or trial) dynamics in the civil actions. To the extent that an adverse determination would have a significant impact on the civil actions, seeking a settlement sooner rather than later may be in the defendants' best interests. ■

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for a strict interpretation of the language of Section 10(b) over the Ninth Circuit's broad interpretation of the statutory language. This strict-interpretation approach has been criticized, however, for failing to address the realities of today's corporate climate where transactions involve numerous "nonspeaking" entities such as law firms, banks, and accounting firms.

CONCLUSION

Two tests have emerged for determining whether secondary actors can be held primarily liable for violations of Section 10(b) under Rule 10b-5(a) and (c). The bright-line test championed by the Fifth and Eighth Circuits provides greater protection to secondary actors, whereas the substantial-participation test employed by the Ninth Circuit is more lenient. The dispute between the two tests should be resolved when the Supreme Court turns its attention to the *Charter Communications* case in its October 2007 term. ■

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oral and written promises to BESI during the course of the marketing process for the securities. BESI sought to enforce those promises or, in the alternative, sought to recover reliance damages from Citibank for alleged misrepresentations in those communications. Citibank moved to dismiss, relying in substantial part on the extensive disclaimers in the marketing materials and the offering memoranda that investors were not to rely on any oral or written statements outside the offering memoranda and that no parties had been authorized to make any oral or written representations outside of or contrary to those in the offering memoranda.

The district court (Chief Judge Muksasey) dismissed all of BESI's claims with prejudice. *BESI v. Citibank*, 2003 WL 23018888 (S.D.N.Y. Dec. 22, 2003), *aff'd*, 110 Fed. Appx. 191 (2d Cir. Oct. 6, 2004). In dismissing BESI's claims of oral and written promises during the marketing of the securities, the district court ruled that "disclaimers in the marketing presentations, the Offering Memoranda, and the letter of intent [signed by BESI] 'constitute objective signs' of Citibank's 'expressed intentions' not to be bound by any statements outside of the Offering Memoranda." Further, the court ruled that it was clear from the transaction documents that Citibank intended to be bound only by a written agreement and the only written agreement would be the offering memoranda. The court dismissed the remaining claims on grounds largely similar to those relied upon by the court in dismissing the *SNS Bank* claims. The Second Circuit summarily affirmed that dismissal less than one year later.

WHAT LIES AHEAD

The clear rejection of the claims filed by SNS Bank and BESI was a vindication of CDO investment structures in which the roles of each participant are clearly described and delineated, the market risks clearly spelled out, and disclaimers of reliance prominently displayed. These rulings pose a significant hurdle for other disgruntled investors seeking to recoup their investment losses by pursuing claims against either the SPV or the placement agent and other intermediaries. These two cases will be valuable and binding precedent in any New York litigation in seeking dismissal of investor claims premised on theories of (i) fiduciary duty, (ii) third-party beneficiary standing, and (iii) oral and written representations outside the offering memoranda, provided appropriate disclaimers were provided. As a consequence, investors may elect to pursue their claims in other jurisdictions, away from New York and the United States. Indeed, SNS Bank and BESI could well have brought their claims in their home jurisdictions of the Netherlands and Portugal, respectively. Such non-U.S. jurisdictions could afford local investors a substantial strategic benefit. One way for CDO industry participants to preserve their litigation advantage, on a going-forward basis, would be to provide for mandatory forum-selection clauses that would require investors to bring their claims in New York state and federal courts. Such a clause may be particularly appropriate where CDO investments are marketed to investors in jurisdictions that have weak, ill-developed, or corruptible legal regimes.

In addition to claims by institutional investors in non-U.S. jurisdictions, participants in the CDO industry are likely to face, with increasing frequency, claims by individual investors both in the United States and abroad. The sale of junior tranche securities to such investors in other countries has accelerated at a tremendous pace. Absent mandatory forum-selection clauses, disgruntled investors in these countries may well choose to pursue their claims locally as opposed to in the United States. Even were they to pursue their claims in the United States, they would seek to avoid early dismissal of their claims by focusing on their status as individual investors, as opposed to institutions. As a threshold matter, individual investors may be in a position to allege with greater credibility and specificity the existence of a broader fiduciary relationship with the placement agent or others involved in the sale of the CDO securities. This is especially the case where the investor can allege a long-standing business relationship in which it has reposed trust and confidence in the placement agent or other agent of the SPV and has relied on that person to provide objective investment advice. Even in the absence of such circumstances, an individual investor is more likely to be afforded the benefit of any doubt before his or her claim is dismissed.

While we are aware of no reported New York decisions involving individual investors in the CDO investment context, state and federal courts in New York have been rather permissive in allowing even sophisticated high-net-worth individual investors to pursue claims involving complex derivatives and currency trading investments, where the claims of a similarly situated institutional investor likely would have been dismissed. *See Caiola v. Citibank*, 295 F.3d 312 (2d Cir. 2002). In *Caiola*, the Second Circuit held, among other things, that broad disclaimers of reliance in transaction documents concerning extensive physical and synthetic equity investments did not preclude the plaintiff from pursuing claims premised on alleged oral misrepresentations. For the disclaimers to have been effective, in the analysis of the Second Circuit, they were required to track the substance of the alleged misrepresentation. The effect of *Caiola* on potential claims by CDO investors can be addressed if, at the inception of the investment, the investor executed disclaimers that clearly disavow reliance on oral and written representations outside the transaction documents concerning specific topics, such as investment risk, the structure of the investment, the priority of payments, projected performance of the CDO fund, and the role of the placement agent and other intermediaries.

Given the more than $1 trillion estimated to be invested in CDOs, further litigation is a foregone conclusion. The question is not *whether* such claims will be filed, but *when*. Some of the CDOs that were affected by the default surge in 2000–2002 are still in business and not yet closed out. It is quite possible that some investors may await the maturity of those CDOs before asserting their claims. Moreover, all investors who are invested in CDOs are exposed to the risk of another increase in default rates during the next downturn in the business cycle. The financial press has forecasted a surge in defaults in 2007, and some analysts have predicted default rates in excess of those experienced only five years ago. The recent rise of defaults in the subprime mortgage market has already affected residential mortgage CDOs. If the downturn deepens or broadens and affects a number of different industries, investors could once again experience significant impairment of their invested principal, resulting, undoubtedly, in the assertion of new claims. ■

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1 *E.g.*, *N.Y. Cent. & Hudson River R.R. Co. v. U.S.,* 212 U.S. 481, 495–96 (1909) ("While the law should have regard to the rights of all, and to those of corporations no less than to those of individuals, it cannot shut its eyes to the fact that the great majority of business transactions in modern times are conducted through those bodies, and particularly that interstate commerce is almost entirely in their hands, and to give them immunity from all punishment because of the old and exploded doctrine that a corporation cannot commit a crime would virtually take away the only means of effectually controlling the subject-matter and correcting the abuses aimed at."); 1 U.S.C. § 1 (2005) ("In determining the meaning of any Act of Congress, [including criminal liability statutes,] unless the context indicates otherwise . . . the words 'person' and 'whoever' include corporations, companies, associations, firms, partnerships, societies, and joint stock companies, as well as individuals[.]").

2 Memorandum from Eric H. Holder, Jr., Deputy Att'y Gen., on Bringing Criminal Charges Against Corporations to All Component Heads and U.S. Attorneys (Jun. 16, 1999), http://www.usdoj.gov/criminal/fraud/docs/reports/1999/chargingcorps.html. The Congressional Research Service (CRS) has recently published a detailed resource paper on the DOJ memoranda regarding corporate charging decisions and related issues. *See generally Cong. Research Serv., The Thompson Memorandum: Attorneys' Fees and Waiver of Corporate Attorney-Client and Work Product Protection* (2007), http://opencrs.cdt.org/rpts/RL33842_20070129.pdf.

3 Holder Memo, *supra* note 2.

4 Memorandum from Larry D. Thompson, Deputy Att'y Gen., on Principles of Fed. Prosecution of Bus. Orgs. to Heads of Dep't Components, U.S. Attorneys (Jan. 20, 2003), http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm.

5 Thompson Memo, *supra* note 4.

6 *Id*.

7 Memorandum from Robert D. McCallum, Jr., Acting Deputy Att'y Gen., on Waiver of Corporate Attorney-Client and Work Product Protection to Heads of Dep't Components, U.S. Attorneys (Oct. 21, 2005), *see* http://lawprofessors.typepad.com/whitecollarcrime_blog/2005/10/new_memo_on_att.html.

8 *U.S. Sentencing Guidelines Manual* § 8C2.5 cmt. 12 (2004). Federal district judges are no longer required to follow the guidelines in sentencing pursuant to the Supreme Court's decision in *U.S. v. Booker*, 543 U.S. 220 (2005). A federal sentencing judge has the discretion regarding whether to reduce a sentence under the guidelines, as long as the judge's decision is "reasonable." *Booker*, 543 U.S. at 261–62.

9 Assoc. of Corp. Counsel, *Is the Attorney-Client Privilege Under Attack?* 5 (2005), http://www.abanet.org/buslaw/attorneyclient/publichearing20050421/testimony/hackett1.pdf.

10 ABA Task Force on Attorney-Client Privilege, *Report* (Aug. 2006), http://www.abanet.org/buslaw/attorneyclient/materials/hod/emprights_report_adopted.pdf.

11 *Id*. at 6 (citing ABA Task Force on Attorney-Client Privilege, *Report in Support of Recommendation 111* (Aug. 2005)).

12 *E.g., In re Qwest Communications Int'l Inc*., 450 F.3d 1179 (10th Cir. 2006); *Westinghouse Elec. Corp. v. Republic of the Phil*., 951 F.2d 1414 (3d Cir. 1991).

13 J.P. Finet, *Selective Waiver of Privilege Provision Likely to Be Pulled from Proposed Rule of Evidence*, 5 BNA Corp. Accountability Rep. No. 5, at 115 (Feb. 2, 2007).

14 Memorandum from Paul J. McNulty, Deputy Att'y Gen., on Principles of Fed. Prosecution of Bus. Orgs. to Heads of Dep't Components, U.S. Attorneys (Dec. 12, 2006), http://www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf.

15 *Id*.

16 Rachel McTague, *DOJ's McNulty: Level of Waiver Requests Doesn't Justify Bill to Limit Agency Discretion*, 5 BNA Corp. Accountability Rep. 16, 405 (Apr. 20, 2007).

17 *E.g*., Pamela A. MacLean, *McNulty Memo on Attorney-Client Privilege Blasted for Lack of Change*, Nat'l L.J., Jan. 26, 2007, http://www.law.com/jsp/ihc/PubArticleIHC.jsp?id=1169719351771.

18 *See* Rep. of Investigation Pursuant to Section 21(a) of the Sec. Exch. Act of 1934 and Comm'n Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exch. Act Release No. 44969 (Oct. 23, 2001) [hereinafter *SEC Report*], http://www.sec.gov/litigation/investreport/34-44969.htm; Press Release, Commodity Futures Trading Comm'n, Commodity Futures Trading Comm'n's Div. of Enforcement Clarifies Cooperation Advisory with Respect to the Attorney-Client and Work Product Privileges (Mar. 1, 2007), http://cftc.gov/opa/enf07/opa5296-07.htm; Memorandum from the NYSE on Cooperation, No. 05-65 (Sept. 14, 2005), http://www.nyse.com/RegulationFrameset.html?displayPage=http://apps.nyse.com/commdata/PubInfoMemos.nsf/AllPublishedInfoMemosNyseCom?openview&count=250&RestrictToCategory=currentyear; Memorandum from the NYSE on Factors Considered by the N.Y. Stock Exch. Div. of Enforcement in Determining Sanctions, No. 05-77 (Oct. 7, 2005), http://www.nyse.com/RegulationFrameset.html?displayPage=http://apps.nyse.com/commdata/PubInfoMemos.nsf/AllPublishedInfoMemosNyseCom?openview&count=250&RestrictToCategory=currentyear.

19 Commodity Futures Trading Comm'n, *supra* note 18.

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legislative history that describes the discretion the Commission has and the way that Congress intended that we utilize that discretion[.]" (An audio recording of the SEC's press conference is available at http://www.connectlive.com/events/secnews/.)

Hoping to achieve "clarity, consistency, and predictability" in the way in which the SEC's corporate-penalty authority is used, the SEC listed the considerations it will examine in determining when a corporate penalty is justified, noting that each of the factors was reflected in the statute and its legislative history. It stated that the appropriateness of a penalty against a corporation in a particular case would turn primarily on two factors: the presence or absence of a direct benefit to the corporation as a result of the violation, and the degree to which any shareholders harmed by the corporation's violation would benefit or suffer further harm from a penalty.

In addition to the two principal considerations, the SEC listed additional factors it will consider in determining whether a corporate penalty is justified, including the need for deterrence; the extent of injury to innocent parties; whether participation in the violation was widespread at the corporation; the degree of intent of the individuals involved; the degree of difficulty in detecting the particular violation at issue; the extent to which the corporation undertook remedial steps; and the corporation's cooperation with the SEC and, if applicable, other law enforcement agencies. The SEC did not indicate in the Statement that each of its secondary considerations will be applicable in each case. As courts have done with other multifactor tests applied to SEC requests for particular remedies or relief, which other factors beyond the two primary ones should be applied will depend on the specific facts and circumstances, as the SEC's penalty analysis requires.

In his press-conference remarks, SEC Chairman Cox said that the Statement's penalty guidelines will "inform . . . [the SEC's] future actions" regarding when it seeks corporate penalties. Acknowledging the concerns of Commissioners Glassman and Atkins, Cox said that it was "important not to compound the harm already caused to investors." Cox added that he

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[20] *SEC Report, supra* note 18.

[21] Press Release, Sec. & Exch. Comm'n, Statement of the Sec. & Exch. Comm'n Concerning Fin. Penalties (Jan. 4, 2006), http://www.sec.gov/news/press/2006-4.htm.

[22] *SEC Report*, *supra* note 18.

[23] *Id*. at n.3.

[24] Paul S. Atkins, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks Before the SEC Speaks in 2007 (Feb. 9, 2007), http://sec.gov/news/speech/2007/spch020907psa.htm.

[25] Letter from Karen J. Mathis, Am. Bar Assoc. President, to the Honorable Christopher Cox (Feb. 5, 2007), *see* http://www.abanet.org/poladv/letters/attyclient/2007feb05__privwaivsec__l.pdf.

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hoped the guidelines provided an objective way to appraise the SEC's use of its penalty authority. As he put it, the SEC's penalty decisions "ought not to be a matter of what the judge had for breakfast."

CONCLUSION

The SEC should be commended for heeding the concerns that had been expressed about its pursuit of financial penalties against corporations and explaining the factors that will guide its decisions regarding when corporate penalties are justified. Important questions remain, however. For example, the SEC's Statement on penalties is silent on the criteria the agency will consider in determining the amount of penalties it will seek after it has concluded that penalties are justified. Corporate counsel are left with the overly general standards that differentiate the three tiers of possible penalty amounts in the penalty statute.[6] Nor does the Statement shed light on what exactly will constitute an improper benefit to a corporation or its shareholders justifying a penalty and how such an improper benefit will be measured. The penalty statute refers to the "gross amount of pecuniary gain," suggesting that any improper benefit ought to be one that is readily quantifiable and had a material impact on a corporation's balance sheet or income statement.

It is too early to assess the impact of the Statement on the SEC's enforcement program and its decisions regarding when to seek financial penalties against a corporation. Given the concerns that motivated the Statement, one hopes that the test of time will reveal that the SEC has invoked its penalty authority in a manner consistent with its assurances and Congress's intent at the time the Remedies Act was enacted, avoiding penalties in the absence of improper corporate gain and when a penalty would only further injure a corporation's shareholders. ■

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[1] Memorandum of the Securities and Exchange Commission in Support of the Securities Law Enforcement Remedies Act, at 4, Attachment A to the July 19, 1989 Statement of David S. Ruder before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce.

[2] Submission of the Securities and Exchange Commission Addressing the Issues Identified in the Court's May 19, 2003 Order Concerning the Proposed Settlement of the Commission's Monetary Claims Against WorldCom, *SEC v. WorldCom*, *Inc*., No. 02-CV-4963 (JSR), *at* http://www.sec.gov/spotlight/worldcom/wcombrief060603.pdf (footnote omitted).

[3] Cynthia A. Glassman, Remarks at the 13th Annual Public Fund Boards Forum: The Challenges of Striking a Regulatory Balance (Dec. 6, 2004), *at* http://www.sec.gov/news/speech/spch120604cag.htm.

[4] Cynthia A. Glassman, SEC in Transition: What We've Done and What's Ahead (June 15, 2005), *at* http://www.sec.gov/news/speech/spch061505cag.htm.

[5] Paul S. Atkins, Remarks before the Atlanta Chapter of the National Association of Corporate Directors (Feb. 23, 2005), *at* http://www.sec.gov/news/speech/spch022305psa.htm.

[6] Though it does not answer this lack of guidance in the penalties Statement, Chairman Cox recently announced that the Commission was initiating a new program in which SEC Enforcement Staff will need to first obtain Commission approval and guidance on the range of appropriate monetary penalties in cases where the Staff believes corporate penalties are justified. Christopher Cox, Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference (Apr. 13, 2007), *at* http://www.sec.gov/news/speech/2007/spch041207cc.htm. Cox added that where cases are then settled within the Commission-approved range, Commission approval of the settlement should proceed faster. *Id.* Cox noted that one goal of the new program was consistency and fairness or "horizontal equity" in the Commission's enforcement decisions around the country. *Id.* SEC Enforcement Staff members have traditionally had the authority to negotiate settlement agreements in principle with corporations and individuals subject to approval by the full Commission. Though the goals of faster settlement approvals and fairness and "horizontal equity" in Enforcement Staff and Commission decisions regarding penalties are laudable, the new Commission pre-review process concerning any penalties discussion the Enforcement Staff may subsequently have with company counsel should be implemented to give company counsel notice and a voice in what otherwise will be a one-sided conversation between the Enforcement Staff and the Commission. *See* Christian J. Mixter, *The Securities and Exchange Commission's New Course on Penalties*, 39 BNA Sec. Reg. & L. Rep. 17, 678 (Apr. 30, 2007).

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generally should not exceed five members. *Cendant*, 264 F.3d at 266-67. Other courts have endorsed a similar analysis. *In re Cardinal Health, Inc. Sec. Litig*., 226 F.R.D. 298, 307-08 (S.D. Ohio 2005) (endorsing a "case-by-case evaluation"); *Meyer v. Paradigm Med. Indus*., 225 F.R.D. 678, 681 (D. Utah 2004) (generally no more than 10 members).

Other district courts, however, have refused to appoint groups of unrelated plaintiffs as lead plaintiffs. *E.g., Ruland v. InfoSonics Corp*., Nos. 06cv1231 BTM(WMc), 06cv1233 BTM(WMc), 06cv1309 BTM(WMc), 06cv1331 BTM(WMc), 06cv1378 BTM(WMc), & 06cv1435 BTM(WMc), 2006 U.S. Dist. LEXIS 79144, at *7-*11 (S.D. Cal. Oct. 23, 2006); *In re Cree, Inc. Sec. Litig*., 219 F.R.D. 369, 372 (M.D.N.C. 2003); *In re Critical Path, Inc. Sec. Litig*., 156 F. Supp. 2d 1102, 1112 (N.D. Cal. 2001); *Gluck v. CellStar Corp*., 976 F. Supp. 542, 549 (N.D. Tex. 1997). As one court explained, some courts have done so because "groups of unrelated class members are more likely to abdicate their responsibility to coordinate the litigation to their attorneys, in contravention of the PSLRA's goal to eliminate lawyer-driven litigation." *Rozenboom v. Van Der Moolen Holding, N.V*., No. 03 Civ. 8284(RWS), 2004 U.S. Dist. LEXIS 6382, at *11-*12 (S.D.N.Y. Apr. 14, 2004). Recently, a California district court held that "[m]any of the cases appointing co-lead plaintiffs . . . appear to be fundamentally at odds with [the Ninth Circuit]'s interpretation of the PSLRA." *Tanne v. Autobytel, Inc*., 226 F.R.D. 659, 673 (C.D. Cal. 2005). In particular, the court was concerned about *In re Cavanaugh*, 306 F.3d 726, 729-31 (9th Cir. 2002), in which the Ninth Circuit spoke in terms of a single lead plaintiff when explaining that "the district court must consider the losses allegedly suffered by the various plaintiffs" and select as the "presumptively most adequate plaintiff . . . the one who has the largest financial interest in the relief sought by the class and [who] otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure."

Companies facing securities actions should be vigilant in monitoring these two PSLRA lead-plaintiff issues and should consider appropriate challenges to would-be lead plaintiffs and groups of lead plaintiffs.

CONCLUSION

Congress' efforts to reform securities-fraud class-action litigation have given rise to several difficult issues that have divided the federal courts. The issues discussed in this article are only a few of the questions that the Acts' provisions raise but which federal courts have not conclusively answered. Companies facing such suits should be attentive to these issues and give careful consideration to how they can encourage courts to address them in a manner that befits the purpose of the Acts: reducing and eliminating problems with and abuses in securities-fraud class actions. ■

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included in the putative class. Defendants in such actions will be well advised to address such allegations in detail to demonstrate that the "core" of the alleged fraud took place outside the United States. In a world of transnational securities markets, and with a growing assumption in many quarters that all information is global, this will become increasingly difficult to do. However, decisions such as *Blechner* and *Bayer AG* suggest that the courts may still be convinced to refrain from extraterritorial application of the U.S. securities laws. ■

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