

The Advocate

Spring 2011

FOR INSTITUTIONAL INVESTORS

Too Big to Fail or Too Big to Challenge?

***As Wall Street Outmaneuvers
the Government, Institutional
Investors Fill the Void***

Rebalancing the System

*Institutional Investors Fight For
Corporate Governance Reform*

How Did We Get Here?

*Remembering the Real Causes
of the Economic Meltdown*

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As we go to press, revelations are emerging almost daily regarding the greed of some of the most powerful executives in Corporate America. From some of the largest corporations and conglomerates on the planet, we are seeing insider trading and self-dealing at the highest levels. Clearly, Corporate America has not found religion.

All the while, the world continues to suffer from the fallout caused by Big Finance's mortgage blowout. In this edition of *The Advocate*, we focus on the role that institutional investors are playing in bringing some measure of justice and recompense in the wake of the financial collapse, the impact they are having in changing behavior in the boardroom, and the very real threats to shareholder rights that still exist.

In our cover story, "Too Big to Fail or Too Big to Challenge?" (page 4), firm associate Ross Shikowitz highlights the failure of our government regulators to truly take on the banks and executives responsible for the financial crisis and the continued efforts of institutional investors to seek justice through private litigation.

On page 16, firm associate Amy Miller takes a fascinating look at precedent-setting litigation successes that are preventing self-dealing and corporate wrongdoing by executives in "Rebalancing the System."

Firm partner Blair Nicholas raises key concerns for shareholders in "How Did We Get Here?" (page 22) as he analyzes the diminished state of investor protections and the ongoing attempts by corporate interests to recast regulatory oversight and private securities litigation as dangers to our economy — even as our country continues to suffer from the repercussions of the financial industry's excesses.

As always, you will find a compilation of the most significant recent developments in securities litigation, regulation and corporate governance in our regular "Eye on the Issues" column.

Please note that we always make the current issue of *The Advocate* (as well as all past issues) available on our website at www.blbglaw.com, and if you need any help in tracking down current or archival essays please do not hesitate to contact us.

The Editors

Too Big to Fail or Too Big to Challenge?

By Ross Shikowitz

As Wall Street
Outmaneuvers the
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Two and half years removed from the worst financial crisis since the Great Depression, the investing public has grown increasingly frustrated with the lack of criminal prosecutions of, and absence of truly significant fines levied against, the senior executives and companies responsible for igniting the subprime meltdown. Pundits have criticized the Securities and Exchange Commission (the "SEC") and the Department of Justice (the "DOJ") as capitulating to the interests of "big finance," citing SEC settlements that have been characterized as mere "slaps on the wrist" and the DOJ's failure to convict a single executive responsible for creating the "great recession" despite significant evidence of intentional misconduct.

For decades, the public's trust in the integrity of U.S. capital markets was a source of economic stability and unparalleled prosperity. To maintain this trust, investors must believe that they compete on a relatively equal playing field and that the laws governing the markets will be

strictly enforced. In furtherance of these goals, violators of federal rules face civil penalties from the SEC or criminal prosecution by the DOJ. In connection with previous corporate scandals, the government held a significant number of the principal wrongdoers civilly and criminally accountable for their misconduct. In the wake of the current financial crisis, however, many argue that the lack of such accountability has eroded the public's faith in U.S. capital markets.

Now, more than ever, private lawsuits are needed to supplement the existing regulatory structure, both to ensure that shareholders are adequately compensated for their losses and to send a strong message that fraudulent conduct will not be tolerated. Indeed, institutional investors continue to vigorously prosecute suits against the companies and executives at the heart of the mortgage crisis, well after the SEC and DOJ have shuttered their civil and criminal investigations. While it remains to be seen whether government regulators will eventually force Wall



Street executives to answer for their improprieties, it is clear that sophisticated public pension funds will continue to play an essential role in obtaining compensation for injured investors and deterring future wrongdoing by corporate executives.

Wrongdoers Have Largely Escaped Government Penalties

While the SEC has reached several settlements in connection with misconduct related to the financial meltdown, those settlements have been characterized as “cheap,” “hollow,” “bloodless,” and merely “cosmetic,” as noted by Columbia University law professor John C. Coffee in a recent article. Moreover, one of the SEC’s own Commissioners, Luis Aguilar, has recently admitted that the SEC’s penalty guidelines are “seriously flawed” and have “adversely impact[ed]” civil enforcement actions. “We continue to have in place...a misguided approach to how to weigh factors one considers when deciding whether to seek a corporate penalty...and the Commission fails to appropriately focus on deterrence,” Aguilar explained.

Perhaps the most cogent criticisms of the inadequacy of the SEC’s settlements with companies and their senior officers can be found in rulings from federal judges considering whether to approve such agreements. For example, Judge Jed Rakoff castigated the SEC for its attempted settlement of charges that Bank of America failed to disclose key information to investors in connection with its acquisition of Merrill Lynch (“Merrill”), including that Merrill was on the brink of insolvency (necessitating a

massive taxpayer bailout), and that Bank of America had entered into a secret agreement to allow Merrill to pay its executives billions of dollars in bonuses prior to the close of the merger regardless of Merrill’s financial condition. The SEC agreed to settle its action against Bank of America for \$33 million in August 2009, even though its acquisition of Merrill resulted in what *The New York Times* characterized as “one of the greatest destructions of shareholder value in financial history.” In rejecting the deal, Judge Rakoff declared that the proposed settlement was “misguided,” “inadequate” and failed to “comport with the most elementary notions of justice and morality.” Indeed, Judge Rakoff described the agreement as “[a] contrivance designed to provide the SEC with the façade of enforcement and the management of the Bank with a quick resolution of an embarrassing inquiry.” When the SEC later submitted a revised \$150 million settlement for approval, Judge Rakoff reluctantly approved the agreement while “shaking [his] head,” explaining that it was “paltry” in nature and “[w]hile better than nothing, [was] half-baked justice at best.”

Similarly, federal Judge Ellen Huvelle criticized the SEC’s \$75 million settlement of its charges that Citigroup concealed \$40 billion of subprime exposure from investors. As part of the agreement, the SEC fined two Citigroup executives—former CFO Gary Crittenden and investor relations chief Arthur Tildesley Jr.—a combined \$180,000, though Crittenden alone pocketed \$19.4 million during the time of his alleged wrongdoing. Judge Huvelle questioned the fairness of the

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SEC settlements have been characterized as mere “slaps on the wrist,” and the Department of Justice has failed to convict a single executive responsible for creating the “great recession,” despite significant evidence of intentional misconduct.

deal, adding that, “for the life of [her],” she could not understand why the SEC only charged Crittenden and Tildesley and failed to pursue claims against other Citigroup executives. Strikingly, the SEC did not require Crittenden, Tildesley, or Citigroup to admit to wrongdoing to resolve the claims, and as Judge Huvelle remarked in approving the settlement, “[t]here’s nothing in here to address a flawed system; not a thing.”

Federal judges have not been the only ones to criticize the SEC’s settlements. Journalists have portrayed the SEC’s agreements with corporations and their senior officers as “paltry” and a “win” for executives, and have chastised the regulator when it failed to impose any penalty whatsoever. For instance, in a recent *Rolling Stone* essay, Matt Taibbi described the SEC’s failure to levy sanctions against Lehman Brothers (“Lehman”) and its former CEO, Dick Fuld, as “tantamount to the state marching into Wall Street and waving the green flag on a new stealing season.” Nevertheless, as recently reported by *The Wall Street Journal*, it appears increasingly unlikely that Fuld and other high-ranking Lehman executives will face any meaningful repercussions from the U.S. government despite the two thousand-page bankruptcy examiner’s report detailing the company’s use of deceptive accounting practices and its most senior executives’ knowledge and approval of those practices. Among other things, the bankruptcy examiner concluded that “colorable” legal claims existed against Fuld and other top Lehman executives, as well as Ernst & Young, the auditor that blessed Lehman’s financial statements. Lehman’s utilization of accounting gim-

micks “paint[ed] a misleading picture of its financial condition” by masking tens of billions of dollars in debt from investors each quarter. Fox Business Network Senior Correspondent Charlie Gasparino recently reported that Fuld “act[s] as if he has nothing to worry about,” and revealed that a source close to Fuld stated that the ex-Lehman CEO “fears private litigation more than [government] enforcement action over his role in Lehman’s bankruptcy.” Ernst & Young, which currently faces civil fraud charges from the New York Attorney General’s office for its role in Lehman’s accounting, has not been charged by federal authorities despite evidence uncovered by the bankruptcy examiner demonstrating that Ernst & Young knew about the manipulative accounting practices.

The SEC was also recently criticized for failing to tack fraud claims onto its “record” \$550 million settlement with Goldman Sachs (“Goldman”) in July 2010, even though the company admitted that it failed to disclose critical information to investors relating to its ABACUS transaction, a deal that was “born-to-lose,” according to Taibbi. Specifically, Goldman chose not to tell its clients that prominent hedge fund manager John Paulson had selected the securities included in the ABACUS vehicle, while at the same time betting against the value of those same securities. Indeed, because of the strength of the claims against Goldman and the concurrent criminal probe by the DOJ, many investors expected a settlement in excess of \$1 billion. John Carney, a CNBC senior editor, noted that in light of the deal, “somewhere Goldman’s lawyers and executives are probably pop-

ping the cork on a bottle of bubbly. This settlement was a win for them.”

Academics have also questioned whether the SEC’s recent civil penalties are sufficient to punish and deter misconduct. Columbia University law professor John C. Coffee recently published an article suggesting that the SEC’s settlement with Countrywide Financial’s (“Countrywide”) CEO Angelo Mozilo was far from equitable. The SEC charged that Mozilo and other Countrywide executives misled investors regarding the company’s risky loan portfolio as the mortgages it originated and securities it generated transformed a recession into a full-blown crisis. The SEC’s complaint revealed that Mozilo himself authored emails that described the company as “flying blind,” explained that the company’s loans were “poison,” and described one category of Countrywide loans as “the most dangerous product in existence...there can be nothing more toxic.” Indeed, Mozilo admitted in his emails that he “personally observed a serious lack of [underwriting] compliance” and recognized that “it was just a matter of time that we will be faced with...much higher delinquencies.” Nonetheless, in October 2010, the SEC agreed to settle the action against Mozilo for \$67.5 million, lauding the settlement as a “record penalty.” Coffee highlights that Mozilo, who was not required to admit to any wrongdoing, paid only \$22.5 million of the settlement because Bank of America (and its shareholders) indemnified Mozilo for \$45 million. These figures are even more egregious when juxtaposed with Mozilo’s estimated \$140 million in profit reaped from his insider trading of Countrywide stock. As Coffee questions,

“[i]s \$22.5 million a successful outcome for the SEC where the defendant retains the other \$117.5 million of his estimated \$140 million in profits?”

Significantly, as described by Coffee, Mozilo was “in an especially vulnerable position” because the SEC civil trial was looming and could have provided federal prosecutors with the information necessary to indict and prosecute the executive. Instead, following the settlement, the DOJ closed its criminal investigation of Mozilo in February 2011 without taking any action against him. This oft-characterized “hollow victory” bolsters the view that executives consider government penalties and sanctions to be a mere “cost of doing business” and illustrates the absence of meaningful deterrence in financial markets.

The DOJ has faced similar criticism for its lack of prosecutions. Documentary filmmaker Charles Ferguson, whose film “Inside Job” won the 2011 Academy Award for Best Documentary for its examination of the financial crisis, recently decried the DOJ’s relative paucity of prosecutions during his Oscar acceptance speech. “Forgive me, I must start by pointing out that three years after our horrific financial crisis caused by financial fraud, not a single executive has gone to jail, and that’s wrong,” Ferguson said. In response to similar criticism a few months prior, the DOJ proclaimed the “successes” of its financial fraud task force “Operation Broken Trust.” So far, however, the task force has not shined a light into executives’ corner offices at the corporations that placed the global economy in peril. Instead, observers have criticized

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The DOJ has proclaimed the “successes” of its financial fraud task force “Operation Broken Trust.” Observers, however, have criticized the task force for targeting hundreds of “petty thieves” who committed small-time frauds. Some claim this demonstrates that the DOJ is either unwilling or unable to hold Wall Street titans accountable for their role in the subprime bust.

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Further, a review of the DOJ’s recently released statistics supporting Operation Broken Trust’s purported accomplishments reveals that the DOJ’s figures are, at best, unsupported. As columnists such as Andrew Ross Sorkin of *The New York Times* and Jonathan Weil of *Bloomberg* have detailed, several of the criminal and civil cases touted by the DOJ were commenced before Operation Broken Trust was initiated, and certain of the criminal convictions that the DOJ highlighted did not lead to any criminal sanctions whatsoever.

The lack of meaningful government sanctions raises legitimate questions as to whether corporate executives will continue to evade responsibility for their actions. Many have described the financial crisis as “unexpected” or “unforeseeable.” In contrast, the recent report from the Financial Crisis Inquiry Commission (“FCIC”) makes clear that the mortgage meltdown was an avoidable event born of fraud, as well as of failures in corporate governance and risk management. Significantly, the FCIC explicitly concluded that banks selling mortgage products failed to disclose critical information to investors. Indeed, a former president of one of the top mortgage research companies testified before the FCIC that, even though approximately 28 percent of the loans issued to homeowners with poor

credit examined by his company failed to meet even basic underwriting standards, nearly half of those loans were nevertheless packaged and unloaded onto unsuspecting investors. According to publicly released emails, “vomit” and “crap” were the terms of art used by UBS employees in 2007 to describe the company’s asset-backed securities; a Bear Stearns Deal Manager wrote in 2006 that investors were being sold a “SACK OF S**T.”

Nevertheless, in response to this accumulating evidence, the SEC and the DOJ have remained largely silent. Are large, systemically important institutions and their ilk too big to be threatened with sanctions that approximate the size of the frauds perpetrated against the public? Has “too big to fail” transformed into “too big to challenge?”

The relative lack of prosecutions stemming from the financial meltdown stands in sharp contrast to the government’s response to past corporate malfeasance. The criminal cases arising from the Savings and Loan scandals of the 1980s and 1990s, where some of the biggest kingpins—including Charles Keating of Lincoln Savings & Loan and roughly 3,800 other bankers—were thrown behind bars, as well as the Enron and WorldCom accounting debacles in the early 2000s where Jeffrey Skilling, Kenneth Lay and Bernard Ebbers were jailed, demonstrated that executives would be held accountable for their crimes. This time, the public is left wondering whether the U.S. government possesses the appropriate tools to adequately police its markets and protect against future misconduct. As prominent hedge fund manager David

Einhorn recently told *The New York Times*, “since there have been almost no big prosecutions, there’s very little evidence that [the government] has stopped bad actors from behaving badly.” Simply put, without forcing executives to answer for their misconduct, no amount of financial reform will restore public trust in government or the markets.

Regulatory Impediments

While many accuse the SEC and DOJ of being “gun shy” with regard to cases against high profile executives, several commentators note that the SEC and DOJ are significantly underfunded. The funding problem is especially acute at the SEC, where budgetary constraints hamper the agency from fulfilling its most basic obligations. For example, the SEC’s travel restrictions limit on-site visits to financial firms and have confined such investigations to locations near SEC offices. Further, lack of funding forced the SEC to cap the number of expert witnesses it hires, significantly hindering its ability to litigate actions where defendants have seemingly unlimited resources. SEC Chairperson Mary Schapiro recently stressed that budget constraints were thwarting the agency’s ability to enforce the securities laws, and House Representative Barney Frank (D-Massachusetts) emphasized that the SEC is unable to carry out its mandate at its current rate of funding. While fiscal 2012 budget proposals include a \$316 million increase to SEC funding, it remains unclear what percentage, if any, of this increase will be realized in the current political climate.

Quotable

“Forgive me, I must start by pointing out that three years after our horrific financial crisis caused by financial fraud, not a single financial executive has gone to jail, and that’s wrong.”

Documentary filmmaker Charles Ferguson, whose film “Inside Job” — an examination of the 2008 financial crisis — won the 2011 Academy Award for Best Documentary, during his acceptance speech on February 27, 2011.

Beyond underfunding, many observers point to the free flow of SEC and DOJ officials between the government and private sector as contributing to lackluster regulatory enforcement. This “revolving door” of personnel fosters “regulatory capture,” which aggravates the conflicts of interest that materialize between regulators and the regulated. Concern arises when skilled high-level public employees gain significant experience and abandon their posts for the private sector where they may earn millions of dollars per year. Similar issues emerge when private sector employees seek government regulatory positions and ultimately oversee their former peers. In his recent essay, Matt Taibbi portrays an environment in which SEC officials and Wall Street bankers attend cocktail hours where “[e]very single person had rotated in and out of government and private service,” and the attendees joke how neither the regulators nor the law firms representing Wall Street could exist without each other. As Taibbi describes, the SEC settlement with Citigroup illustrates that the revolving door may cause agency officials to bestow

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preferential treatment upon executives at the large financial institutions the SEC regulates. Specifically, according to an anonymous letter that spawned an internal investigation, Robert Khuzami, the SEC Director of Enforcement, ordered his staff to drop fraud claims against Citigroup executives Crittenden and Tildesley after a “secret conversation, without telling the staff, with a prominent defense lawyer who is a good friend of Khuzami’s...and who was counsel for [Citigroup].”

Further, to the bewilderment of numerous observers, Khuzami recently stated that it would be the SEC’s general policy going forward to act as “middle man” between the DOJ and Wall Street financiers and to provide potential defendants with information as to whether the DOJ plans to pursue litigation arising from their alleged misconduct—a procedure that critics have described as conflicting with the SEC’s own enforcement manual. Recognizing the inherent conflicts in this practice, Senator Charles Grassley (R-Iowa) explained that “[a]ll the promises of financial regulatory reform ring hollow if the administration is allowing the top enforcement official at the SEC to relay to potential targets of an investigation exactly what the Justice Department has in store for them.”

Lack of funding and regulatory capture notwithstanding, the SEC is being provided with additional tools to combat fraud while private litigants are not being afforded similar weapons. For example, the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) extends the jurisdiction of federal district courts to adjudicate SEC and DOJ actions involving securities transactions

consummated outside the United States—a jurisdictional hook that is unavailable to private litigants under a recent Supreme Court ruling. Dodd-Frank also failed to reverse recent Supreme Court precedent that stymied private litigants’ attempts to recover from so-called “secondary actors” such as bankers, auditors, lawyers and accountants who fanned the flames of the financial meltdown by issuing favorable audit opinions or legal advice to Wall Street firms. While the SEC and DOJ may hold such “aiders and abettors” accountable, columnists agree that the agencies have failed to do so. Such enforcement mechanisms in the capable hands of institutional investors, however, would mark an important beginning to deterring future crimes and restoring the public’s faith in financial markets.

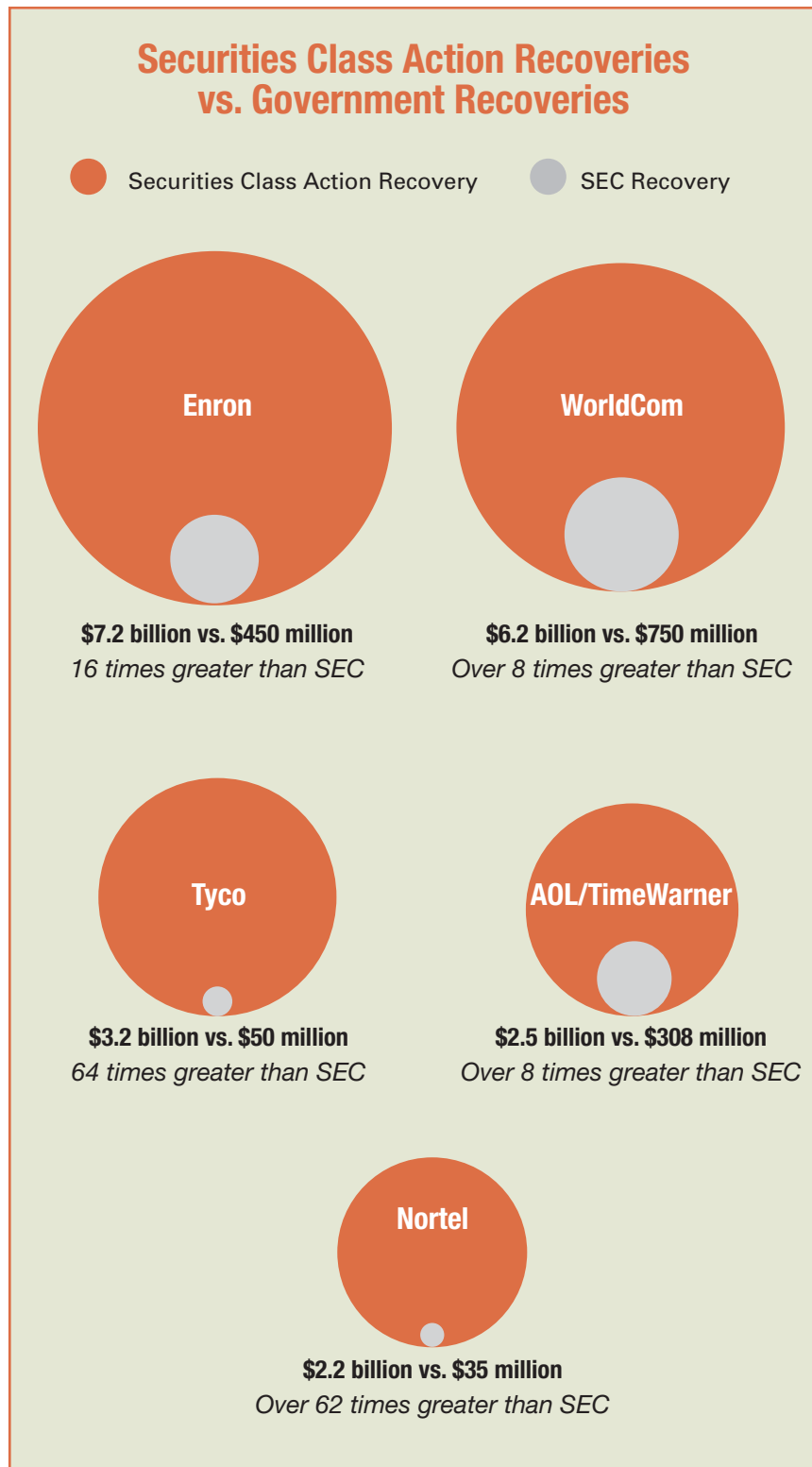
How Institutional Investors are Filling the Void

It has increasingly fallen to institutional investors to hold mortgage lenders, investment banks and other large financial institutions accountable for their role in the mortgage crisis by seeking redress for shareholders injured by corporate misconduct and sending a powerful message to executives that corporate malfeasance is unacceptable. For example, sophisticated public pension funds are currently prosecuting actions involving billions of dollars of losses against Bank of America, Goldman Sachs, JPMorgan Chase, Lehman Brothers, Bear Stearns, Wachovia, Merrill Lynch, Washington Mutual, Countrywide, Morgan Stanley and Citigroup, among many others. In some instances, litigations have already resulted in significant recoveries for defrauded investors.

Historically, institutional investors have achieved impressive results on behalf of shareholders when compared to government-led suits. Indeed, since 1995, SEC settlements comprise only 5 percent of the monetary recoveries arising from securities frauds, with the remaining 95 percent obtained through private litigation as demonstrated by several examples in the chart at right.

Institutional investors must continue to lead the charge and prosecute fraud to send a strong message that such misconduct will not be tolerated and to guarantee that shareholders are fairly compensated for their losses. Both the courts and Congress have recognized that meritorious private securities litigation is “an indispensable tool with which defrauded investors can recover their losses[,]...promote public and global confidence in our capital markets and help to deter wrongdoing.” While originally intended as a supplement to government regulation, recent events demonstrate that institutional investors may now be the entities best positioned to protect investors’ rights. Without such protection, and if Wall Street bankers are permitted to profit from their frauds without a proportionate retributive response, we may be fated to repeat the same economic calamity that has defined our generation.

Ross Shikowitz is an associate in BLB&G’s New York office. He can be reached at ross@blbglaw.com.



Eye on the issues

By Katherine Sinderson

Supreme Court Sides With Investors

On March 22, 2011, the Supreme Court issued a unanimous opinion rejecting arguments by Matrixx Initiatives that, under the securities laws, adverse drug event reports must be “statistically significant” to be material to investors. In *Matrixx*, shareholders had brought claims related to the company’s failure to disclose reports linking its leading product, Zicam cold remedy, to a loss of smell for some users. The Court emphasized that such a “categorical rule would artificially exclude information that would otherwise be considered significant to the trading decision of a reasonable investor.” As a result of the Court’s decision, those claims will now be going forward.

>> *Matrixx Initiatives, Inc. v. Siracusano*, 09–1156 (U.S. Mar. 22, 2011).



Jury Verdict Stands in *Apollo* Securities Litigation

On March 7, 2011, the U.S. Supreme Court denied the Apollo Group’s petition to review a jury award of \$277.5 million for plaintiffs in *In re Apollo Group Securities Litigation*. A jury had entered a verdict in favor of the plaintiff class on all counts in January 2008, but the district court judge reversed the jury’s verdict, finding that the trial testimony did not support the jury’s finding of liability. In June 2010, the Ninth Circuit reversed, ruling that the district court “erred in granting Apollo judgment as a matter of law” and instructed the trial court to enter judgment in accordance with the jury’s verdict. The Supreme Court’s refusal to review the Ninth Circuit’s decision means that the *Apollo* jury verdict will stand.

>> *Apollo Group, Inc., et al. v. Policemen’s Annuity & Benefit*, 10-649 (U.S. Mar. 7, 2011)

Trial Court Cuts Jury Award in *Vivendi* Securities Litigation by 80 Percent

On February 22, 2011, a New York district court entered an order substantially narrowing a jury verdict for plaintiffs in the *Vivendi* securities litigation based on the U.S. Supreme Court’s subsequent ruling in *Morrison v. National Australia Bank*. In *Morrison*, the Supreme Court held that Section 10(b) of the Securities Exchange Act does not apply to securities transactions consummated on foreign exchanges. On the basis of *Morrison*, the *Vivendi* court amended the previous class certification definition to exclude all purchasers of Vivendi shares sold on foreign exchanges. The court’s decision excludes more than 80 percent of the damages previously assessed by the jury.

>> *In re Vivendi Universal, S.A., Securities Litigation*, 02-05571 (U.S.D.C., S.D.N.Y. Feb. 17, 2011)

SEC Probe into Lehman Looks Likely to Stall

Stunningly, there may be no civil or criminal charges filed against Lehman Brothers' former executives resulting from the federal government's investigation into the collapse of the investment firm. According to sources cited by *The Wall Street Journal*, SEC officials are doubtful that they can demonstrate that Lehman violated the securities laws through its infamous "Repo 105" accounting maneuvers, through which Lehman exchanged certain assets for cash directly before reporting quarterly results, promising to repurchase the assets. As Lehman's court-appointed bankruptcy examiner put it, this had the effect of "paint[ing] a misleading picture of [Lehman's] financial condition." The SEC declined to comment on their investigation.

>> *The Wall Street Journal*, March 12, 2011

Quotable

"...[Dick Fuld] fears private litigation more than enforcement action over his role in Lehman's bankruptcy."

Anonymous source "close to" former Lehman CEO Richard Fuld who spoke to FOX Business News for a story published Feb 22, 2011 ("As Lehman Inquiry Drags on, Fuld's Business Takes Off")

NY Federal Judge Rakoff Strikes Again; Takes SEC to Task for Settlement Practices

On March 21, 2011, the Honorable Jed S. Rakoff of the Southern District of New York again criticized the Securities and Exchange Commission's enforcement practices. In approving a \$3 million settlement agreement between the SEC and Vitesse Semiconductor and former executives over the improper accounting of revenue and the backdating of stock options, Judge Rakoff expressed disdain over the SEC's expectation of the court to be a "rubber stamp" as well as the hypocritical and confusing nature of boiler-plate language used in nearly every securities regulatory settlement: that the defendants agree to settle "without admitting or denying wrongdoing." Judge Rakoff stated that "the public will never know whether the



S.E.C.'s charges are true, at least not in a way that they can take as established by these proceedings....[The practice] raises difficult questions of whether accepting settlements in which the defendants neither admit nor deny the S.E.C.'s allegations meets the standards necessary for approval by a district court."

>> *SEC v. Vitesse Semiconductor Corporation, et al.*, (U.S.D.C., S.D.N.Y., 10 Civ. 9239 (JSR))

SEC Prosecutes Former Goldman Sachs Director for Insider Trading

On March 1, the SEC brought an administrative action against Rajat K. Gupta, a former Goldman Sachs Group Inc. board member, for insider trading. The SEC alleged that Gupta passed confidential information to Galleon Group founder Raj Rajaratnam. Rajaratnam, who is fighting SEC and Justice Department insider-trading claims, went to trial March 8, and the jury heard tape-recorded conversations between Gupta and Rajaratnam about internal Goldman discussions regarding possible investments. District Judge Jed Rakoff, who is presiding over the SEC's action against a former Galleon trader, termed the SEC's decision to bring an administrative action — instead of a court proceeding — "bizarre."

>> <http://www.businessweek.com/news/2011-03-16/gupta-administrative-action-by-sec-is-bizarre-judge-says.html>

Fannie Mae Executives May Potentially Face Civil Charges from the SEC; Some Still Skeptical

The former chief executive of Fannie Mae, Daniel Mudd, has received a formal notice (a “Wells notice”) that the SEC plans to pursue civil claims against him over Fannie Mae’s failure to accurately disclose to investors its exposure to risky mortgages. Other former Fannie executives have also reportedly received Wells notices. Columnist Jonathan Weil of *Bloomberg*, however, described as “incredible” the SEC’s decision not to include accounting violations among the claims against the executives. According to Weil, the failure to bring accounting charges “may be by design. The SEC for years has been bending over backward to avoid accusing major financial institutions of cooking their books, even when it’s obvious they did.”

>> *The Wall Street Journal*, March 14, 2011; *Bloomberg*, March 16, 2011

WaMu Executives Target of First FDIC Lawsuits

On March 16, 2011, two and a half years after the failure of Washington Mutual Bank, the Federal Deposit Insurance Corporation brought suit against former WaMu CEO Kerry Killinger and two other WaMu executives for negligently operating the bank. The suit alleges that the WaMu executives recklessly took



WaMu CEO Kerry Killinger

“extreme and historically unprecedented risks” in WaMu’s residential lending, leading to the bank losing billions of dollars and being seized by the FDIC in September 2008. The suit is the first FDIC suit against any executive of a major bank in the wake of the financial crisis. The suit seeks to recover \$900 million from the executives and names the wives of two of the executives as defendants for allegedly fraudulently transferring assets in order to elude judgment. The WaMu executives issued denials of the FDIC’s allegations.

>> *FDIC v. Killinger*, 11-00459 (U.S.D.C., W.D. Wash.)



Jury Finds Former Homestore CEO Liable for Federal Securities Law Violations

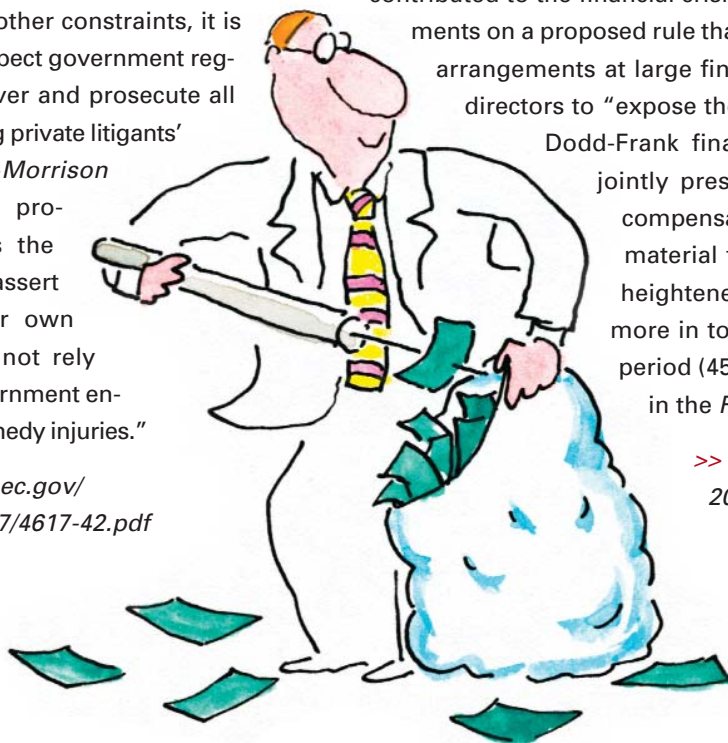
On February 24, a California jury rendered a verdict on behalf of plaintiffs against the former CEO of Homestore, Stuart H. Wolff, for violations of the federal securities laws. The plaintiffs alleged that the company had engaged in a scheme to create a circular flow of money, where it purchased advertising on different websites and then had a portion of the cash returned in advertising purchases to Homestore’s website. This maneuver created the illusion of a growing company and propped up the company’s stock price, all while Wolff and other executives were selling their shares. Damages in the suit have not yet been determined.

>> *In re Homestore.com, Inc. Securities Litigation*, 01-11115 (U.S.D.C., C.D. Cal. Feb. 24, 2011).

International Pension Funds Call for *Morrison* Reversal

A coalition of international pension funds has called for legislation to reverse the Supreme Court's decision in *Morrison v. National Australia Bank*, which held that Section 10(b) of the Securities Exchange Act does not apply to securities transactions consummated on foreign exchanges. These investors, which manage more than \$2 trillion in assets, submitted a comment letter to the SEC after the agency was directed by the Dodd-Frank Act to study whether investors should be able to sue over alleged transnational securities fraud. In their letter, the pension funds argue that investors should have the same ability to bring lawsuits over transnational securities fraud as the SEC. The coalition contends that private litigation is necessary to protect investors. According to the letter, "because of budgetary and other constraints, it is unrealistic to expect government regulators to uncover and prosecute all frauds. Restoring private litigants' rights to pre-*Morrison* levels simply provides investors the opportunity to assert claims on their own behalf, and to not rely entirely on government enforcement to remedy injuries."

>> <http://www.sec.gov/comments/4-617/4617-42.pdf>



Katherine Sinderson is an associate in BLB&G's New York office. She can be reached at katherinem@blblaw.com

Business Roundtable and the U.S. Chamber of Commerce Challenge New Rules on Board Nominations

The U.S. Court of Appeals for the D.C. Circuit recently heard argument regarding challenges to the validity of SEC Rule 14a-11, a recently adopted rule that would allow long-term shareholders to nominate board candidates to appear on company proxy statements. After the SEC adopted the rule — which allows investors to nominate candidates at large issuers if the investors have held at least three percent of the company's shares for at least three years — the Business Roundtable and the U.S. Chamber of Commerce filed suit to block the rule, contending that the SEC acted in an arbitrary and capricious manner in its treatment of state corporate laws. A final ruling is expected later this year.

>> *Business Roundtable v. SEC*, 10-1305 (D.C. Cir)



Comment Period Begins on Proposed Executive Compensation Rules

Citing concerns that "flawed incentive compensation practices in the financial industry" contributed to the financial crisis, federal financial regulators are eliciting comments on a proposed rule that would prohibit incentive-based compensation arrangements at large financial institutions that encourage officers and directors to "expose the institution to inappropriate risks." The recent Dodd-Frank financial reform law required the regulators to jointly prescribe regulations prohibiting incentive-based compensation that was likely to lead to excessive risk and material financial loss. The proposed rule also includes heightened standards for institutions with \$50 billion or more in total assets. There will be a shortened comment period (45 days) on the proposal following its publication in the *Federal Register*.

>> <http://www.sec.gov/news/press/2011/2011-77.htm>

Rebalancing the System

By Amy Miller

Institutional Investors Fight For Corporate Governance Reform

Corporate directors and senior executives, together with aggressive corporate and legal advisors, have always sought to push the balance of power in corporations in their favor. Recently, however, institutional investors have been pushing back more aggressively by pursuing legal action as a means to reform corporate governance practices. As public pension funds and other institutional investors recognize, a meaningful result in such actions can not only provide significant benefits to the company involved in the suit, but also serve as an example for other companies to follow. This article takes a look at some of the most notable successes in achieving corporate governance reforms over the past year.

The Pfizer Derivative Action

In a derivative action, shareholders can assert a lawsuit on behalf of a corporation against its management or board of directors for their breach of fiduciary duties. Derivative actions provide good opportunities to improve corporate governance practices at public companies because these lawsuits can target improper conduct by directors or senior executives specifically related to their management of a company and, if successful,

can directly affect how a company is run going forward. The recent success by institutional investors in forcing corporate reforms at the drug company Pfizer following years of illegal marketing activities provides a prime example of the potential for significant changes achievable through derivative litigation, even in a company that had repeatedly resisted reform.

For nearly a decade, Pfizer engaged in illegal marketing practices to sell its drugs. In 2002, Pfizer was forced to pay \$49 million to settle allegations concerning the payment of illegal kickbacks to promote its anti-cholesterol drug "Lipitor." Pfizer also entered into a corporate integrity agreement that increased the responsibilities of Pfizer's senior management and board of directors to oversee drug promotion. In 2004, one of Pfizer's subsidiaries pled guilty to criminal charges related to illegally marketing another Pfizer drug, "Neurontin," for uses that were not approved by the U.S. Food and Drug Administration ("FDA"). Pfizer also agreed to pay \$430 million in criminal and civil fines, and entered into an even more extensive corporate integrity agreement, making the board directly responsible for overseeing Pfizer's drug promotion. Notwithstanding these prior penalties and corporate integrity agreements, in



Pfizer's pattern of misconduct, and the resulting felony pleas, put it at risk of being excluded from contracting with the federal government, including Medicare and Medicaid, thereby subjecting the company and its shareholders to potentially devastating consequences.

2009 Pfizer agreed to pay \$2.3 billion in fines and civil settlements — including the largest criminal fine in U.S. history (\$1.3 billion) — to resolve allegations that, over a seven-year period, Pfizer promoted at least four of its drugs for uses that were not approved by the FDA, and nine others by paying illegal kickbacks to doctors. This pattern of misconduct, and the resulting felony pleas, put Pfizer at risk of being excluded from contracting with the federal government, including Medicare and Medicaid, thereby subjecting Pfizer and its shareholders to potentially devastating consequences.

In September 2009, several institutional investors filed a derivative action against Pfizer's senior management and board to stop Pfizer's systemic law-breaking and

and every member of the board [was] entirely reasonable."

Following intense litigation, including the review of millions of pages of documents, the taking of 35 depositions, the presentation of hundreds of pages of expert reports (including reports by two former Chairmen of the SEC), and the briefing of summary judgment motions, the plaintiffs achieved a landmark settlement. Under the terms of the settlement, Pfizer is required to create a new "Regulatory and Compliance Committee of the Board of Directors" with a broad mandate to oversee and monitor Pfizer's compliance and promotion practices, and a specific charge to evaluate whether patterns of improper marketing exist that suggest systemic misconduct. The Regulatory Committee will receive detailed information about the promotion of Pfizer's most important drugs and any serious allegations of wrongdoing. The Committee can retain its own experts, consultants and counsel to properly evaluate this information and to take the necessary steps to stop any wrongdoing. The settlement also requires the defendants' insurance carriers to pay \$75 million into a separate fund for the exclusive use of the Regulatory Committee. In addition to overseeing Pfizer's drug promotion practices, the Regulatory Committee must also review Pfizer's compensation policies and recommend a possible clawback of incentive compensation for any wrongdoers and their supervisors in the case of any future misconduct. Moreover, the settlement requires the defendants to create an ombudsman program that will provide Pfizer employees with an alternative channel to voice work-related concerns,



Institutional investors filed a derivative action against Pfizer's senior management and board to stop Pfizer's systemic marketing violations and prevent more in the future.

Result: In a landmark settlement, Pfizer is required to create a new regulatory and compliance committee with a broad mandate to oversee and monitor Pfizer's compliance and promotion practices funded by the litigation's \$75 million settlement.

ensure that management and the board would take appropriate steps to prevent similar drug marketing violations in the future. As the court noted in denying defendants' motion to dismiss the action, the complaint alleged "misconduct of such pervasiveness and magnitude, undertaken in the face of the board's own formal undertakings to directly monitor and prevent such misconduct, that the inference of deliberate disregard by each

including, for example, any complaints of pressure from supervisors to engage in improper promotional activities. Each of these reforms was directly responsive to the institutional plaintiffs' allegations and deep concerns about management's commitment to Pfizer's long-term interests.

In sum, the settlement created a self-funded corporate governance mechanism that is directly aimed at improving Pfizer's system of checks and balances and the company's corporate culture by ensuring that the board has the time and resources to focus on a critical element of Pfizer's operations: compliance with drug marketing laws. The Pfizer derivative lawsuit demonstrates that derivative actions can force changes in a large corporate structure — even at a company that has resisted change for years. The settlement has received very favorable coverage in the press, in particular concerning the settlement's unprecedented creation of a board committee charged with direct responsibility for the company's regulatory compliance as opposed to general oversight responsibility, and the advance funding of the settlement's corporate governance reforms with \$75 million. Accordingly, corporate governance experts expect the settlement to set an industry standard for pharmaceutical companies and other companies in heavily regulated industries by encouraging them to create board committees that are directly responsible for their companies' regulatory compliance practices before shareholders assert derivative actions that force them to do so.



Institutional investors filed suit challenging special payments to controlling shareholder.

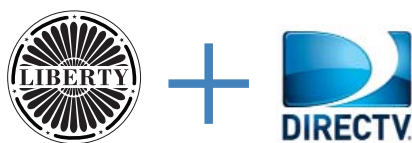
Result: *ACS's public shareholders succeeded in negotiating a settlement under which the controlling shareholder was required to personally contribute nearly 20 percent of a \$69 million cash fund in additional consideration for ACS's public shareholders.*

Improving Corporate Governance Practices in the Merger & Acquisition Context

Institutional investors have also achieved substantial results in their efforts to bring about better corporate governance practices in the context of a board's decision to sell a company. Recent shareholder class actions brought by institutional investors have made significant progress by challenging: (1) disparate merger consideration for different classes of stock; and (2) deal protections that make it more difficult, if not impossible, for third parties to pursue a successful bid for a company.

In the recent litigation concerning the sale of Affiliated Computer Service, Inc. ("ACS") to the Xerox Corporation, shareholders challenged certain deal terms that provided ACS's controlling shareholder, who also served as the company's chairman, with hundreds of millions of dollars in additional consideration for his high-vote stock (i.e., a class of stock that provides a shareholder with multiple votes per share of stock) at the direct expense of ACS's public shareholders. After

Institutional investors have also achieved substantial results in their efforts to bring about better corporate governance practices in the context of a board's decision to sell a company.



Institutional investors challenged the fairness of a merger transaction in which the chairman tried to use his high-vote stock to extract a large personal premium at the expense of other shareholders.

Result: The settlement ensured the fairness of the transaction and sent a powerful warning to the holders of high-vote stock in other companies not to line their own pockets at the expense of public shareholders.

a hard-fought litigation, ACS's public shareholders succeeded in negotiating a settlement under which the controlling shareholder was required to personally contribute nearly 20 percent of a \$69 million cash fund in additional consideration for ACS's public shareholders. This victory for shareholders sent a clear message to corporate boards that shareholders will not tolerate the payment of a premium to high-vote shareholders at the expense of other investors.

Similarly, institutional investors challenged the fairness of a merger transaction between the DirectTV Group, Inc. and Liberty Media Corporation in which the chairman of both merging companies — who was a high-vote stockholder in each company — tried to use his high-vote stock to extract a large personal premium at the expense of other shareholders in a subsequent acquisition of the merged companies. Shareholders were ultimately able to secure a settlement that ensured the fairness of the transaction by, among other things: (1) requiring the merger and any subsequent acquisition to be approved by a majority of the public shareholders; (2) implementing restrictions on the high vote stockholder's ability to purchase additional common stock; and (3) providing the public shareholders with increased power to require the board of directors to call and hold a special meeting of stockholders. The results in these two cases send a powerful warning to the holders of high-vote stock in other companies not to extract additional consideration at the expense of public shareholders in mergers and acquisitions.

Institutional investors are also improving corporate governance practices by chal-

lenging deal protections in merger agreements to ensure that boards maximize value for their shareholders when they decide to sell their companies. Through the years, many courts have approved the use of deal protections in merger agreements. Deal protections allow a company to favor a preferred bidder. Deal protections can take many forms, such as a termination fee, which is paid to a preferred bidder if the target company accepts another bidder's offer, or a matching right, which provides a preferred bidder with the right to match another bidder's offer to remain the preferred purchaser of a company. In circumstances where a board has either conducted a market check or an auction before agreeing to such deal protections, these protections may be appropriate. In many cases, however, boards agree to deal protections without adequately ensuring that they are maximizing value for shareholders in the transaction.

Several recent cases demonstrate how institutional investors are beginning to force corporate boards to change the way they view deal protections, providing more opportunities to maximize shareholder value. In the Landry's Restaurants Inc. ("Landry's") class action and derivative litigation, an institutional investor sued Landry's board, including its special committee, and the company's CEO, chairman, and controlling shareholder, Tilman Fertitta, for breaching their fiduciary duties in connection with Fertitta's attempts to take Landry's private. Among other things, the suit challenged the special committee's grant of numerous deal protections to Fertitta, its preferred bidder. Following more than a year of litigation, the parties

reached a settlement, which included many important corporate governance reforms to these deal protections in order to correct the flawed sales process conducted by the special committee. First, defendants agreed to institute a new 45-day “go-shop” period, a time to allow other bidders the opportunity to bid for Landry’s under new sales terms. Second, the settlement eliminated the required payment of a termination fee to the preferred bidder and provided cost reimbursement incentives of up to \$500,000 for the two highest bidders if Landry’s ultimately decided to proceed with a deal with the preferred bidder instead of those bidders. In addition, the settlement allowed plaintiff’s counsel to monitor the go-shop process and provide comments on proxy disclosures to further ensure the fairness of the sales process. These changes to the deal protections fixed a seriously flawed sales process and ultimately allowed Landry’s public shareholders to receive merger consideration that increased from \$14.75 to \$24.50 per share in cash. Institutional investors have also had recent success in modifying or eliminating unwarranted deal protections in actions against Alberto-Culver (relating to its merger with Unilever) and the J. Crew Group, Inc. (relating to its leveraged buy-out).

Corporate advisors and public companies are clearly taking notice of recent successes by institutional investors in challenging deal protections. For example, shortly after the announcement of the J.Crew settlement, the board of directors of BJ’s Wholesale Warehouse (“BJ’s”) — which had received an expression of interest in acquiring BJ’s from a private equity firm nearly six months earlier —



Alberto Culver



Unilever

J.CREW



Several recent cases demonstrate how institutional investors are beginning to force corporate boards to change the way they view deal protections, providing more opportunities to maximize shareholder value.

Result: *The Landry’s settlement ultimately allowed public shareholders to receive merger consideration that increased from \$14.75 to \$24.50 per share in cash.*

decided that it would conduct a full auction to maximize shareholder value in any potential sale. Media reports hypothesized that BJ’s decision to conduct a full auction was intended to prevent a repeat of the perceived flaws in the J. Crew sale process.

While much work remains to be done to combat the self-dealing and conflicts of interest present in many corporate management structures, by pursuing actions derivatively on behalf of corporations, and directly on behalf of shareholders, institutional investors are holding boards and senior management responsible for systemic governance failures and improving corporate governance practices in many important ways. Little by little, institutional shareholders are returning some power to public shareholders and balancing the allocation of power in corporations.

Amy Miller is an associate in BLB&G’s New York office. She can be reached at amy@blbglaw.com.

Let's See Now... How Did We Get Here?

By Blair Nicholas

Too Much Regulatory Oversight or Not Enough?

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in the March 10, 2011 issue of
The Recorder, California's leading
legal industry daily.*

Corporate interest groups are again singing the same old song that less regulation is needed to revive competitiveness in the U.S. capital markets. Having spent the last three years seeing up close the damage done by the subprime meltdown and financial collapse, I am astounded to see corporate interest groups continue to trumpet several now thoroughly discredited arguments about our capital markets and what makes them function properly. It reminds me of the lyrics from the Talking Heads' song "Burning Down the House":

*"Hold tight — wait till the party's over,
Hold tight — we're in for nasty weather."*

For example, some corporate interests continue to argue that the Committee on Capital Markets Regulation (also known as the "Paulson Committee" for its close association with former Treasury Secretary Henry Paulson) warned back in 2006 that the United States was losing its position as the world's foremost public cap-

ital market due to the unpredictability of private securities litigation, and that it has now been left to the Supreme Court to resolve some of the supposed inconsistency. These same corporate interests also applaud the High Court for deciding three recent private securities litigation cases which have limited investor protections. They argue that these cases strike a careful balance between preserving the private securities class action as a deterrent against fraud and the risk of "over-enforcement" that would further erode the competitiveness of our public capital markets.

To me, the fundamental premise is deeply flawed — both for relying on the assertions of the Paulson Committee that America's capital markets need less investor protection to thrive, as well as for the supposed and potential impact of



The same prominent officials who claimed that overzealous regulation was stifling competitiveness, and that financial institutions could “police themselves,” now blame the global financial crisis on the failure of regulatory oversight.

these Supreme Court decisions. It makes me wonder if these corporate interest groups have ever seen the rain.

The Paulson Committee

In November 2006, the Paulson Committee issued its “Interim Report” to great fanfare. In those bright, antediluvian days prior to the subprime crisis and near collapse of the financial markets, the Report proclaimed that overzealous regulation was stifling competitiveness, financial institutions could “police themselves,” and that London might eventually replace Wall Street as the world’s top financial center. At the very same time the 148-page interim report was being trumpeted to the public, there were emerging stunning and pervasive instances of corporate fraud, governance breakdowns, credit rating agency incompetence and a complete lack of government oversight and regulation over broad swaths of our capital markets.

Fast forward to today, and the same prominent officials, once belting out praises for the Paulson Committee, have pivoted on a dime, shoved aside the Paulson Report as if it never existed, and now blame the global financial crisis on the failure of regulatory oversight. This was not the first time that Henry Paulson wrongly predicted the future by ignoring the obvious. As the Financial Crisis Inquiry Commission noted in its January 2011 report, Paulson wrongly predicted in 2007 — by a cavernous margin — that the subprime meltdown would be contained. Clearly, the Paulson Committee’s doom and gloom about the competitive impact of private securities litigation has now been relegated to the laugh jar — particularly

at a time when the SEC continues to be woefully underfunded to perform its basic regulatory functions, and private securities litigation has accounted for the bulk of investors’ recoveries stemming from the financial crisis.

The Supreme Court: Eroding Investor Protections

Likewise, the Supreme Court’s recent “landmark” decisions in *Morrison*, *Stoneridge*, and *Tellabs* are nothing to be applauded. Indeed, these decisions have eroded investor protections in numerous ways and weakened investor protection in the U.S. markets.

Morrison

Corporate interest groups have called the Supreme Court’s decision in *Morrison v. NAB* the securities case “most likely to positively affect the U.S. public capital markets.” Nothing could be further from the truth. *Morrison* allows corporations to escape civil liability for federal securities fraud violations simply by removing their securities from listing on U.S. exchanges in favor of foreign exchanges. How does incentivizing companies to shift their securities trading away from our public capital markets positively affect the competitiveness of those markets? I’m the product of the public school system, but I’m educated enough not to buy that lemon of an argument.

What *Morrison* really means is that foreign corporations now have a clear path to commit securities fraud in the U.S. with little fear of significant civil judgments in U.S. courts. While the Dodd-Frank Act preserves the SEC’s powers to prosecute

foreign-listed companies that commit securities fraud in the U.S., the commission has publicly admitted that it has limited resources necessary to enforce the federal securities laws. At a time when Congress is battling over spending cuts and considering freezing or reducing the SEC's budget, private enforcement of the securities laws should be embraced as a critical tool in maintaining the integrity of the U.S. financial markets.

Perhaps even more damaging to the U.S. capital markets is the effect of *Morrison* on many large institutional investors. Large institutional investors, which manage the retirement systems of the overwhelming majority of the population, are now potentially faced with the daunting prospect of initiating individual securities litigation in a multitude of foreign countries even where the issuer maintains a substantial presence in the U.S., pervasive fraudulent conduct occurred in the U.S., buying and selling decisions were made here, and the effects of corporate fraud were felt by millions of Americans. How can one argue that the federal securities laws should not protect American investors in these circumstances? The only "certainty" that *Morrison* injects into our enforcement standards is that in many cases, U.S. investors will have no meaningful opportunity for redress in U.S. courts. Talk about whistling past the graveyard.

What is critical to the continued competitiveness of the U.S. capital markets is for Congress to immediately repudiate *Morrison* and restore the long-standing "conduct and effects" test for private enforcement of securities law violations.



This test was established by decades of appellate court precedent to prevent this country from becoming a "Barbary Coast" for foreign-listed companies to commit securities fraud here with impunity. Shielding corporate fraudsters from federal securities liability based solely on the location of a stock exchange — without any consideration of the surrounding circumstances — is overly simplistic and flies in the face of the essential purposes of the federal securities laws, to protect investors and deter corporate fraud within our borders.

Stoneridge

Corporate interest groups also like to point to the Supreme Court's decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta Inc.* as "progress" in resolving supposed uncertainties in the

Corporate mouthpieces have called the Supreme Court's decision in Morrison v. NAB the securities case "most likely to positively affect the U.S. public capital markets." Nothing could be further from the truth. Morrison allows corporations to escape civil liability for federal securities fraud violations simply by removing their securities from listing on U.S. exchanges in favor of foreign exchanges.



In Tellabs, the Supreme Court specifically observed that “private securities litigation is an indispensable tool with which defrauded investors can recover their losses — a matter crucial to the integrity of domestic capital markets.” Contrary to the rhetoric of Corporate America, not a single justice described private securities litigation as dampening competitiveness in the U.S. markets.

reliance element of a federal securities fraud claim. In *Stoneridge*, the court reiterated that “secondary actors” in a corporate fraud — such as bankers, auditors, lawyers and business partners — cannot be held liable by private litigants for assisting or participating in the fraud unless the victims can prove they specifically relied on those actors in making investment decisions. It is still unclear to me how holding accountable corporate fraudsters — either as the getaway driver or as the actual robber — is bad for business or the U.S. financial markets.

In *Stoneridge*, the Supreme Court majority danced on the head of a pin by reasoning that if a fraud takes place in the marketplace of goods, it is somehow “too remote” to justify investor reliance on honest dealing. Isn’t a fraud a fraud? If a fraud takes place in the marketplace of goods with the goal of intentionally inflating the company’s financial results, isn’t that exactly what the federal securities laws are supposed to protect against? If the primary rationale for *Stoneridge* is that it may be bad for American competitiveness to hold otherwise, Justice John

Paul Stevens’ dissent reminds us that the prospect of federal securities fraud liability “will not harm American competitiveness; in fact, investor faith in the safety and integrity of our markets is their strength. The fact that our markets are the safest in the world has helped make them the strongest in the world.”

To ensure the U.S. public capital markets are the safest in the world, Congress should repudiate *Stoneridge* and restore liability for those who intentionally participate in a scheme to defraud shareholders or otherwise aid and abet securities fraud violations. The current law simply permits fraudsters to act in the shadows and effectively evade accountability for their fraudulent conduct.

Tellabs

Corporate interests have praised the Supreme Court’s decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* as being a net positive for U.S. capital market competitiveness. They praise the High Court for imposing a more stringent “comparative evaluation” standard for pleading scienter, which they believe fosters opportunities for defendants to win dismissal of securities class actions early, thus minimizing their litigation costs. On the other hand, they point out that the new pleading standard drives up the settlement value of claims that survive a motion to dismiss because it increases the odds that only meritorious claims will do so.

In *Tellabs*, the Supreme Court rejected the invitation of certain corporate interest groups — including many of the same groups that publicly supported the now-defunct Paulson Committee — to require

that a securities fraud complaint allege facts so compelling that the inference of defendants' guilty state of mind is stronger than any competing inference that defendants acted innocently. Had the court accepted this argument, most meritorious securities fraud cases would be thrown out the window at the pleading stage. Instead, the Court held that a complaint should not be dismissed if the inference of fraudulent intent is "cogent" and at least as strong as any opposing inference.

Perhaps more importantly, *Tellabs* reiterated that private securities litigation provides a critical supplement to government enforcement of the securities laws by the SEC and the Department of Justice. The Court specifically observed that "private securities litigation is an indispensable tool with which defrauded investors can recover their losses — a matter crucial to the integrity of domestic capital markets." Contrary to the rhetoric of Corporate America and the Paulsonites, not a single justice — including Antonin Scalia and Samuel Alito, who each penned separate opinions advocating a higher pleading standard — described private securities litigation as dampening the competitiveness of the U.S. markets.

Conclusion

As the Supreme Court has repeatedly recognized, private enforcement of the federal securities laws is critically important to maintaining the integrity and transparency of the U.S. capital markets. To encourage further obstacles to private securities actions in the vein of reviving competition (as the Paulson Committee proposed) is nothing more than an invitation for more

securities fraud. The argument that increased protection for fraudsters would result in U.S. capital markets being more competitive is downright ludicrous. As the unfortunate events of the last several years demonstrate, the U.S. public capital markets need more policing in order to maintain their competitive edge. And for anyone within earshot of those who have not put away their Paulson Committee badges, in the words of The Who: "Don't Get Fooled Again."

Blair Nicholas is a partner in BLB&G's California office. He can be reached at blairn@blbglaw.com.

How to Contact Us

We welcome your letters, comments, questions and submissions. *The Advocate's* editors can be reached at:

Boaz Weinstein:

(212) 554-1586 or boaz@blbglaw.com

Jon Worm:

(858) 720-3194 or jonw@blbglaw.com

Editors: Boaz Weinstein and Jon Worm

Editorial Director: Alexander Coxe

"Eye" Editor: Katherine Sinderson

Contributors: Amy Miller, Blair Nicholas, and Ross Shikowitz

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BLB&G Bernstein Litowitz
Berger & Grossmann LLP

800-380-8496

E-mail: blbg@blbglaw.com

New York

1285 Avenue of the Americas, New York, NY 10019
Tel: 212-554-1400

California

12481 High Bluff Drive, San Diego, CA 92130
Tel: 858-793-0070

Louisiana

2727 Prytania Street, New Orleans, LA 70130
Tel: 504-899-2339



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Laughs & Laments



"Honesty is the best policy." O.K.! Now, what's the second-best policy?"

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In some cases : CRIME DOES PAY!



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