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INSTITUTIONAL INVESTOR

Advocate

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To Scheme Or Not To Scheme…

By Noam Mandel

I'd like to tell you a story about some barges.

In the late 1990s a collection of electricity-generating barges were moored off the coast of Nigeria. These vessels were essentially floating power plants providing electrical energy to the mainland. At the time, the barges were owned by an energy trading concern out of Houston called Enron Corp.

But Enron had a problem. Wall Street analysts were projecting financial results that the company simply could not provide. In an effort to satisfy the Street's expectations, Enron tried to sell the barges in the hope that it could book revenue from the transaction and meet expectations for the quarter. The company could not, however, find a legitimate willing buyer.

Enter investment banking firm Merrill Lynch & Co. with a solution simple enough to be criminal. Rather than actually selling the barges, Enron could simply "park" the assets with Merrill Lynch, book revenue from the supposed "sale" to meet projections, and then unwind the phony transaction once the quarter had been reported. That is, Merrill Lynch would pretend to "buy" the barges from Enron and then, once the financial reporting consequences of that sham deal had been foisted on the investing public, Merrill Lynch would pretend to "sell" the barges back to Enron. Of course, Enron bought back the barges from Merrill Lynch at a hefty premium because the investment bank was certainly not about to let Enron park its assets for free and, in order to maintain the charade that this was a legitimate sale of assets, they had to disguise Merrill Lynch's fees as something else.

The Nigerian barge transactions were a blatant fraud that quite obviously served no legitimate business purpose. In fact, their ***only*** purpose was to create a false impression of Enron's financial performance and condition, artificially inflating the company's stock price through a

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fraud on the market. As the U.S. District Court in Texas presiding over the Enron litigation, *Newby v. Enron Corp. Sec., Deriv. & "ERISA" Litigation,* put it, the transaction involved:

> [P]urchasing Nigerian barges from Enron to create sham earnings…in return for a secret, oral side agreement…that Enron would repurchase them within six months so there would be no risk, but only a lucrative profit for Merrill Lynch. Merrill Lynch knew the Nigerian barge deal was a phony transaction created to manipulate Enron's income statements in return for Merrill Lynch's lucrative 15% return.

Likewise recognizing the deceptive nature of this Nigerian barge scheme, the U.S. Department of Justice continues to seek criminal convictions against individuals involved at Merrill Lynch.

Although liability for "aiding and abetting" securities fraud had been eliminated by the 1994 Supreme Court decision in *Central Bank of Denver v. First Interstate Bank of Denver*, this was clearly something else: direct, knowing, and active participation in a scheme whose only possible purpose could be to defraud. In

Inside Look

Max Berger

This quarter, the *Advocate* focuses on one of the most important and hotly contested issues facing defrauded investors today: the viability of "scheme liability." The theory of scheme liability involves holding the silent partners in corporate fraud — those who do not themselves issue false public statements, but who undertake deceptive acts in concert with those who do make false statements — accountable for violations of the securities laws. In other words, can investment banks, vendors and other third parties that actively participate in fraudulent transactions with the Enrons and WorldComs of the world for the purpose of inflating those companies' financial results be held liable? This is the precise question currently under review by the Supreme Court in *Stoneridge Investment Partners v. Scientific-Atlanta.*

In "To Scheme or Not To Scheme…," BLB&G associate Noam Mandel discusses the legal issues at play in this current controversy. He also details the current administration's efforts to limit this critical avenue of recovery for investors seeking justice. In this regard, Noam explains the far-reaching implications of the Supreme Court's upcoming decision, which could include the potential foreclosure of any recovery in cases where the primary wrongdoer is bankrupt.

In light of the importance of the Supreme Court's decision, scheme liability is also on the minds of corporate America and the institutional investment community. On July 17 of this year, *The Wall Street Journal* featured a lively debate on the topic between two of the nation's premier securities litigators — BLB&G Partner Sean Coffey and Sullivan & Cromwell's Robert Giuffra. In this exchange (re-published with permission on page 8), Mr. Coffey provides the investor plaintiff perspective and Mr. Giuffra presents the views of the defense bar.

I also direct your attention to the regular "Eye on the Issues" column. Firm associate Laura Gundersheim has again provided a perceptive compilation of the most significant recent developments in securities litigation and corporate governance. In particular, Laura discusses Chief Justice John Robert's recent move to "un-recuse" himself from participating in the Supreme Court's consideration of scheme liability in *Stoneridge*. Laura also reports on the recent developments in the stock options backdating cases against Brocade Communications and its former CEO, and much more.

On page 12, Benjamin Galdston (Advocate Co-Editor and BLB&G associate) examines the Governmental Accounting Office's September report on the SEC's ability to timely investigate and resolve cases of securities and financial fraud. The GAO's study reveals serious deficiencies in the SEC's internal systems, which have caused many cases to languish for years without resolution, while injured investors are denied recompense for years. The GAO's findings also raises serious questions about the role of political considerations in the SEC's decisions to selectively prosecute some cases while "mothballing" others.

This issue of the *Advocate* also comes as we prepare for our 13th Institutional Investor Forum, which is being held on October 11-12, 2007 in New York City. The Forum will host over 100 guests from the international pension fund and institutional investor community, and has become one of the top educational events in the field. We hope to see you this October in New York or at future events.

We trust that you will enjoy this issue of the *Advocate*. As always, we strive to make it informative and insightful. We welcome your comments, questions and input.

Max W. Berger

light of the deceptive nature of the transactions, the massive swindle of which they were a part, the widespread damage they caused, and the Justice Department's apparent conclusion that the underlying misconduct warrants criminal prosecution, one might think that policy-makers are unanimous that third parties — like Merrill Lynch — should be liable for their direct and knowing participation in fraudulent schemes that harm investors.

Think again.

On October 9, 2007, the U.S. Supreme Court will hear oral argument in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.,* a case that squarely addresses this very issue — i.e., the civil liability under the federal securities laws of third parties who actively participate in a deceptive scheme that harms investors but do not actually make a public statement as part of that misconduct. Unfortunately, the executive branch of the U.S. government has already thrown its weight into the fray, with the Solicitor General coming out against investors' interests and contrary to the recommendation of the Securities and Exchange Commission ("SEC"). The Solicitor General's legal theory would-and is intended to-have the practical impact of immunizing a wide class of potential defendants who actively engage in fraudulent transactions, such as the Nigerian barge deals, but who are smart enough to keep their mouths shut about their misconduct.

The *Stoneridge* case involves a scheme similar to the Nigerian barges. Charter Communications, Inc. is a cable-television company that purchases the set-top cable boxes provided to its customers from Scientific-Atlanta, Inc. and Motorola, Inc. Unable to meet its operating cash flow projections for 2000, Charter and the third-party defendants — Scientific-Atlanta and Motorola — hatched a scheme in which Charter would pay extra for the cable boxes and Scientific-Atlanta and Motorola would then route the extra sums back to Charter in the form of phony "purchases" of advertising, which falsely inflated Charter's operating cash flows and, therefore, its stock price.

The SEC's review of *Stoneridge* concluded that Scientific-Atlanta and Motorola could be liable under existing law to Charter's investors for their participation in the cable-box scheme, a conclusion consistent with longstanding positions held by the SEC. In 1934, Congress enacted the Securities Exchange Act which established the SEC and introduced Section 10(b), which makes it "unlawful for any person, directly or indirectly…[t]o use or employ, in connection with the purchase or sale of any security…any manipulative or deceptive device or contrivance in contravention of" SEC rules. Shortly thereafter, the SEC made use of this rulemaking authority by promulgating Rule 10b-5, which, in addition to outlawing false or misleading statements in connection with securities transactions, also proscribes participation in fraudulent schemes by imposing liability on persons who "directly or indirectly… employ any device, scheme or artifice to defraud" or "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 a security." More recently, in *Simpson v. AOL Time Warner Inc.,* an appeal from a case involving the securities of Homestore, Inc., the SEC submitted a 2006 *amicus curiae* ("friend of the court") brief urging that "[a]ny person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator" and that "engaging in a transaction, the principal purpose and effect of which is to create a false appearance of revenues" was itself an unlawful "deceptive act."

In accordance with this position, the SEC decided, by majority vote of its Commissioners in May 2007, to recommend that the Solicitor General submit an *amicus curiae* brief in the *Stoneridge* case supporting the plaintiffs' position. As the Supreme Court noted in *U.S. v. O'Hagan,* the SEC is the principal U.S. agency responsible for administering the federal securities laws, and its opinions on the interpretation of its own rule — Rule 10b-5 — are therefore, and under long-established legal principles, entitled to "more than mere deference" but rather to "controlling weight" so long as they are not "arbitrary, capricious, or manifestly contrary to the" Securities Exchange Act. Asked about the SEC's recommendation in favor of the plaintiffs in *Stoneridge*, SEC Chairman — and former Republican Congressman — Christopher Cox testified to the House Committee on Financial Services that:

> [T]he *Stoneridge* case was very similar to a prior case that the

In light of the deceptive nature of the transactions, the massive swindle of which they were a part, the widespread damage caused thereby, and the Department of Justice's apparent conclusion that the underlying misconduct warrants criminal prosecution, one would think that policy-makers and investors were unanimous in their view that third parties — like Merrill Lynch — should be liable for their direct and knowing participation in a fraudulent scheme that harms investors. Think again.

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> SEC had considered in 2004 called *Homestore*. It was my view, and it is my view generally with respect to decisions that are recently taken by the SEC, that precedent matters. And because *Homestore* and *Stoneridge* were very much on all fours with one another, I thought it was important for the SEC to be consistent and clear on these points…I don't believe that SEC rules or policies should be so effervescent as to change with one or two people coming on board. And I think this is doubly so when what we're doing is trying to interpret law, what law means. Law has to have some objective meaning. It can't just be a question of how we all feel about it.

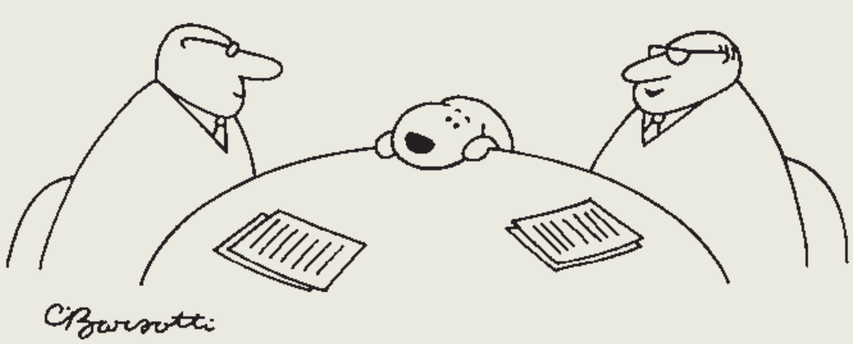
Alas, and in short order, the SEC's recommendation was cast aside — reportedly at the personal insistence of President George W. Bush — in favor of a legal brief supporting the position of the *Stoneridge* defendants. The current administration's rejection of the SEC's recommendation, and its further insistence on filing a brief asserting a directly contrary position, is a slap across the face of the American investor.

In Stoneridge, the SEC's recommendation was cast aside — reportedly at the personal insistence of President George W. Bush — in favor of a legal brief supporting the position of the defendants in the case. The current administration's rejection of the SEC's consistently held position, and its further insistence on filing a brief asserting a directly contrary position, is a slap across the face of the American investor.

Indeed, the departure from the SEC's position was so extraordinary that it prompted three former senior SEC officials to file, after the deadline had expired, an *amicus curiae* brief placing the SEC's position before the Supreme Court. As William H. Donaldson (former SEC Chairman appointed by President George W. Bush), Arthur Levitt, Jr. (former SEC Chairman appointed by President Clinton), and Harvey J. Goldschmid (former SEC Commissioner appointed by President George W. Bush) explained in their submission to the Supreme Court, although they "regret[ted] missing the deadline for filing," they had previously seen no need to file such a brief because they had "expected that the Solicitor General would support the past and current position of the [SEC] on the issue presented and file an *amicus curiae* brief in support of the [plaintiffs]."

Instead, however, the Solicitor General's brief presents a complex legal argument that obscures a simple and utterly absurd proposition: that a third-party who knowingly commits an unlawful act by participating in a fraudulent scheme cannot be liable to investors because the specifics of the scheme were concealed from the investing public. Although the Solicitor General accepts that knowing participation in a scheme to defraud is a theoretical basis for liability to investors, the argument simultaneously asserts, in essence, that if the facts of the scheme never came to light, public investors never "relied" on them and thus cannot hold their perpetrators liable.

This argument is refuted by basic principles of securities jurisprudence. "Reliance" in securities litigation is established through the "fraud on the market" doctrine, which holds that information entering an efficient market (like a major U.S. stock exchange) is incorporated into the public trading price of securities and, therefore, that investors who purchase securities in reliance on the integrity of these markets are, in effect, relying on the underlying information. Thus, an actor that commits a fraudulent act that causes false information to enter the marketplace is committing a "fraud on the market" and investors, who rely on that market and purchase artificially inflated securities, are harmed directly by that fraud. In *Stoneridge*, however, the



"I give you the seven-billion-dollar pup, then you give me back the seven-billion-dollar pup, and we've each made seven billion dollars."

Solicitor General argues that the nondisclosure of the specific facts of a fraud somehow prevents that fraud from harming investors and being subject to legal action. The argument turns the logic of the securities laws on its head because it is the very fact that this information is never revealed that allows the fraudulent scheme to work at all. As the Supreme Court has recognized,

In the end, the current administration's decision to argue against the existence of scheme liability had more to do with politics than with any reasoned application of legal principles.

"nondisclosure is usually essential to the success of a manipulative scheme. No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices." *Sante Fe Indus., Inc. v. Green.*

In the end, the current administration's decision to argue against imposing scheme liability on third parties seems to have had more to do with politics than with any reasoned application of legal principles. Powerful economic forces — large investment banks in particular — could be brought to heel by a clear decision from the Supreme Court articulating their potential liability for the sort of financial misconduct that has become all too commonplace within their organizations. Their argument is one of "flood gates," with opponents of scheme liability providing a steady drumbeat that a decision affirming the potential of such third-party liability would embolden plaintiffs' lawyers who, they say, will then bring ruin to U.S. capital markets. They tell us, in effect, that investors would be better off if they had fewer ways to recover their losses when victimized by fraud.

And if you believe that, there are some barges I would like to tell you about…

Noam Mandel is an associate in BLB&G's New York office. He can be reached at noam@blbglaw.com.

Quarterly Quote...

"We recognize that our ruling on legal merit may not coincide, particularly in the minds of aggrieved former Enron shareholders who have lost billions of dollars in a fraud they allege was aided and abetted by the defendants at bar, with notions of justice and fair play."

Federal appellate Judge Jerry Smith from his March 2007 opinion tossing out a lawsuit by Enron shareholders against the banks that helped the company cook its books

"I cannot understand judges who would look at the people who designed the theft, provided the money to do it and drove the getaway car, and say that they didn't do anything. This country boy has a hard time interpreting these things."

Charles Prestwood, former Enron employee who lost nearly 95% of his retirement savings, which the company had automatically invested in its own stock, responding to the appellate Court's ruling. (May 9, 2007)

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Eye on the Issues

LEGISLATIVE/REGULATORY UPDATES AND RECENT DECISIONS OF INTEREST

By Laura Gundersheim

New Study Finds that Companies Continue to Manipulate Earnings Through Accounting Rules

A study of the financial reports for U.S. publicly traded companies between 1962 and the first quarter of 2004 found strong evidence that companies manipulate their earnings to make themselves look better. Specifically, the study found that nearly 600 companies had at some point reported earnings increases for at least 20 consecutive quarters by manipulating earnings. After taking into account the overall growth of the economy over the last four decades, which could make a company more likely to report profits than losses in any given quarter, as well as the tendency of certain industries to have long periods of above-average economic growth (such as oil companies in recent years), the study determined that no more than 46 companies during that 42-year period should have had earnings-per-share growth for 20 consecutive quarters. In reality, however, 587 companies reported such strings of growth. Accordingly, the study concluded that these findings constitute "*prima facie* evidence of earnings management." The study entitled "Earnings Momentum and Earnings Management," also found that when the average company with 20 consecutive quarterly increases finally experienced a declining quarter, its stock price fell by an abnormally large amount. *The New York Times, Sept. 23, 2007.*

Supreme Court Chief Justice Roberts Sells Shares to "Un-recuse" himself from Stoneridge Case

Earlier this year, Supreme Court Chief Justice John Roberts recused himself from participating in *Stoneridge* — the case that will determine whether shareholders can sue to hold third parties such as investment banks, law firms and accountants liable for a company's fraud — likely due to his ownership of Cisco stock, the parent company of Scientific-Atlanta, a party in the case. Chief Justice Roberts held between $50,001 to $100,000 worth of Cisco stock, according to financial disclosures. On September 21, 2007, the Supreme Court docket indicated that Chief Justice Roberts had "un-recused" himself and will participate in deciding the case. The un-recusal likely means he sold his stock in Cisco. Prior to this turn of events, Stoneridge was set to be heard by only seven justices because Justice Breyer had also recused himself. This is not the first time Chief Justice Roberts un-recused himself in order to rejoin an appeal. Earlier this year, he rejoined a case captioned *Credit Suisse First Boston Ltd. v. Billing,* which held that underwriters were immune from a class-action lawsuit brought under federal antitrust laws over alleged conduct on initial public offerings during the 1990s technology bubble. *Dow Jones Newswire, Sept. 22, 2007.*

Brocade Communications CEO Convicted of Securities Fraud For Options Backdating; Company Settles With Securities and Exchange Commission

On May 31, 2007, the Securities and Exchange Commission ("SEC") approved a settlement with Brocade Communications Systems Inc. ("Brocade"), marking the first time the SEC reached a settlement with a company for backdating stock options. The SEC had alleged that Gregory Reyes, Brocade's former chief executive, president and chairman, provided employees with valuable "in-the-money" stock options. In order to avoid reporting to investors the undisclosed compensation expenses, Brocade's former executives allegedly concealed that the options had been granted "in-the-money" by fabricating records making it appear that the options had been granted at a lower price on an earlier date, the government said. As part of the settlement, Brocade will pay approximately $7 million to the SEC. The settlement has been the subject of negotiation and discussions for more than a year, and should set a pattern for resolution of similar cases. Just two months later, a federal court jury in San Francisco found Reyes, guilty of 10 criminal counts, including conspiracy to commit securities fraud, mail fraud, falsifying books, records and accounts, and making false statements. The verdict ended a five-week trial in which Reyes was accused of intentionally changing the grant dates for hundreds of stock option awards without disclosing the move to investors. Reyes never exercised any of the questionable stock options at Brocade. He sold at least $380 million worth of shares he received before the company went public in 1999. Sentencing is scheduled for November 21, 2007. Under federal sentencing guidelines, Reyes could face up to 20 years in prison for the most serious charges as well as pay millions of dollars in fines. *Bloomberg News, May 31, 2007; The Wall Street Journal, Aug. 8, 2007.*

SEC Enacts New Rule Prohibiting Hedge Fund Advisors from Engaging in Fraudulent Acts

Recently, the SEC unanimously adopted a new rule to the Investment Advisors Act ("IAA") in an effort to curb fraudulent conduct by investment advisers with respect to "pooled investment vehicles" ("PIVs"), such as hedge funds, private equity funds and venture capital funds. This rule, § 206(4)-8 of the IAA, prohibits investment advisers from (1) making false or misleading statements to prospective or actual investors in PIVs; or (2) otherwise defrauding those investors. The SEC adopted the rule in response to the U.S. Court of Appeals for the D.C. Circuit's decision in *Goldstein v. SEC*, which held that the term "client" as defined in the IAA did not encompass investors in PIVs, and thus, cast doubt on the SEC's ability to bring enforcement actions under the IAA in cases where investors in PIVs may have been defrauded by an investment adviser to that pool. The adoption of this new rule clarified the SEC's ability to act on behalf of investors in PIVs. In addition to the newly added § 206(4)-8, the SEC can also bring enforcement actions under other provisions of the IAA to protect investor fund assets by stopping ongoing frauds, barring individuals who have committed certain offenses from associating with an adviser, imposing penalties and ordering disgorgement of "ill-gotten gains." *www.law.com., Aug. 15, 2007.*

Law Firm, Accounting Firms and Investment Banks Sued for more than $2 Billion by Refco Creditors

A court-appointed trustee responsible for recovering funds for Refco Inc. creditors has sought more than $2 billion in damages in a lawsuit against law firm Mayer, Brown, Rowe & Mawe; accounting firms Grant Thornton, Ernst & Young and PricewaterhouseCoopers; and investment banks Credit Suisse Securities, Bank of America and Deutsche Bank Securities, which were involved in Refco's $583 million IPO. The lawsuit was foreshadowed by the 416-page report by bankruptcy examiner Joshua Hochberg, who investigated the roots of the massive fraud at the failed brokerage. In particular, Hochberg found that Mayer Brown knowingly structured "round trip" loans allegedly designed to move bad debt off of Refco's books, and that there was "significant evidence" that Mayer Brown "assisted Refco by drafting and negotiating documents in connection with the round trip loan transactions, which Mayer Brown knew or should have known were fraudulent and undertaken for the purpose of manipulating Refco's financial statements." Hochberg concluded that Refco's bankruptcy estate should be able to state claims and bring claims against Mayer Brown for professional negligence, aiding and abetting fraud, and breaches of fiduciary duty. *The Wall Street Journal, July 11, 2007 & AP, Aug. 23, 2007.*

Campos Resigns from the SEC

On August 9, 2007, Democrat Roel C. Campos, the first Mexican-American and the first prosecutor ever to serve as commissioner, announced his resignation. Campos has a long history of voting to protect shareholder rights. He was one of the three commissioners to support the SEC's decision to ask the Solicitor General to file a brief seeking reversal in *Stoneridge* (a request that was ultimately not honored) and was one of the three that supported shareholder access proposals that would allow shareholders to include in the company's proxy statement bylaw proposals concerning the election of directors. Campos played an active role in advancing shareholder protections and, thus, his replacement on the Commission is crucial. Another Democratic commissioner, Annette Nazareth will also leave the SEC by year-end. *SEC Press Release, Aug. 9, 2007.*

SEC Chairman Cox Splits Vote on Proxy Access

The SEC voted to issue proposed amendments to Rule 14a-8 that would allow shareholders to submit bylaw proposals that address the method of electing directors. The SEC approved by a 3–2 vote a proposal to allow shareholders who own 5% of a company for one year to propose changing bylaws governing how directors are elected (the shareholder access proposal) and approved by a 3-2 vote a proposal that would forbid shareholders from putting forward election-related proposals (the shareholder non-access proposal). Chairman Cox was the deciding vote on both of these election-related proposals, which are now open for public comment. *The Wall Street Journal, July 26, 2007.*

SEC Charges Dozens of Audit Firms and Audit Partners for Taking Part in Auditing Public Companies without Registering

The SEC charged 37 audit firms and 32 audit partners for taking part in the audits of public companies without registering with the Public Company Accounting Oversight Board ("PCAOB"). Most of the audit firms and partners charged settled with the SEC, and received an array of penalties, ranging from censure to the return of allegedly ill-gotten gains. By failing to register, the PCAOB could not properly exercise oversight over the quality of audit work being conducted by these auditors. *The Wall Street Journal, Sept. 14, 2007.*

SEC May Change Policies Regarding Private Securities Litigation

At the behest of six law professors, the SEC has agreed to review its policies pertaining to private securities litigation. The SEC has announced that will hold a roundtable in the first quarter of next year to discuss, among other things, who should bear the cost of paying for attorneys fees in securities lawsuits, the role insurance plays in indemnifying companies or individuals, the percentage of investors who file claims and collect portions of settlements, and how the economics of a settlement change when the defendant is a third party. *The Wall Street Journal, Sept. 24, 2007.*

Study Finds Corporate Fraud Continues To Rise

According to a recent survey of 168 financial executives of public companies, three out of four respondents indicate that institutional fraud is more prevalent today than it was in 2002. The report found that 56 percent of respondents said that they have personally observed financial misconduct in the past year. The report also revealed double-digit percentage increases in incidents of expense and reimbursement schemes (41 percent), and bribery/economic extortion (35 percent) over 2005. *Business Wire, July 11, 2007 & AccountingWEB.com, Aug. 14, 2007.*

Laura Gundersheim is an associate in BLB&G's New York office. She can be reached at LauraG@blbglaw.com.

Debating "Scheme Liability"

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July 19, 2007

For years, Congress, the courts and the Securities & Exchange Commission have struggled to balance the rights of shareholders and companies in securities fraud cases. The latest battle, over whether courts should recognize so-called "scheme liability," is headed to the Supreme Court this fall in a highly-anticipated case called *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc., et al.*

At issue: whether a plaintiff-shareholder should be allowed to recover not only from a company that commits securities fraud, but also from a third party that participates in a fraudulent scheme. A 1994 Supreme Court decision known by lawyers as *Central Bank* barred plaintiffs from recovering against a third party alleged to have "aided and abetted" a securities fraud. Since then, lower courts have divided over whether third parties should be held liable for playing a more central role in a fraud.

The SEC has urged the Bush Administration to file a brief with the Supreme Court supporting "scheme liability." The Treasury Department has taken the opposite stance. The battle lines are drawn.

Plaintiffs lawyer Sean Coffey and defense lawyer Robert Giuffra, both high-profile securities lawyers, recently exchanged views on "scheme liability" and the *Stoneridge* case.

The Participants

Sean Coffey

Sean Coffey is a partner in the New York office of Bernstein Litowitz Berger & Grossmann LLP, which prosecutes class and private actions on behalf of individual and institutional clients. Mr. Coffey served as lead counsel in the *WorldCom Inc.* securities class action against a handful of defendants, a case that yielded a $6.15 billion recovery, and currently serves as court-appointed lead counsel representing investors in the *HealthSouth Corp.*, *Merck & Co.*, *Refco Inc.*, and *Delphi Corp.* securities cases. Mr. Coffey is a graduate of the United States Naval Academy and the Georgetown University Law Center.

Robert Giuffra

Robert Giuffra is a litigation partner at Sullivan & Cromwell LLP in New York. He coordinates S&C's securities litigation practice and is a member of the firm's management committee. He currently represents clients in government investigations and securities class actions involving *Enron Corp.*, *HealthSouth Corp.*, and NYSE specialist trading. He served as chief counsel of the Senate Banking Committee from 1995 to 1996 and was a primary drafter of the Private Securities Litigation Reform Act of 1995 ("PSLRA"). He clerked for Chief Justice William Rehnquist and is a graduate of Princeton and Yale Law School.

Sean Coffey

Where should courts draw the line between third-party conduct that "merely" aids and abets a fraud, and conduct that puts the third party in the thick of the fraud as a direct participant? That is the question the Supreme Court has agreed to tackle next term in *Stoneridge Investment v. Scientific-Atlanta.*

To clear up any confusion: the question is not whether there should be aiding and abetting liability — that issue was settled by the Court's 1994 *Central Bank* decision, in which the Court held that investors could not sue third parties (be they bankers or lawyers or business partners) that had "aided and abetted" an act of securities fraud by a "principal" (typically a publicly traded company and/or its senior managers, who may have fudged the company's financial statements in order to boost the stock price).

Here's an example of the type of conduct that many investors think should subject a third-party to liability: Let's say a company is concerned about coming up short at year end on its cash flow. So senior management arranges to obtain $100 million in cash from Bank A on December 31, the last day of the fiscal year. But rather than paper it as a loan, the company and Bank A arrange for A to pay the $100 million to "buy" a warehouse of widgets that the company has in inventory (which the bank never inspects), and simultaneously execute a side letter requiring the company to "buy" that same inventory back from the bank in a month — after the books have closed for the year — for $105 million.

Bank A knows that the company intends to add the $100 million to its cash flow number even though this transaction is in fact a loan, not a legitimate sale. I respectfully submit that Bank A has participated in a scheme to commit securities fraud and (like the company) should be held accountable to those whom it was foreseeable would be harmed by that scheme — investors.

It is deceptive conduct like this that the theory of "scheme liability" is intended to reach. And it finds its legal roots in an SEC rule called Rule 10b-5, which makes it illegal to engage in "any" scheme to defraud another in connection with the purchase or sale of securities.

A number of hysterical arguments are being thrown about that, in effect, predict the end of capitalism as we know it if "scheme liability" is endorsed by the Court. Since nobody I know makes these arguments better and more persuasively than my friend Bob Giuffra, let me turn it over to Bob.

Bob Giuffra

Well, Sean, there you go again. You pick a troubling fact pattern — a Wall Street bank's alleged involvement in a phony sale of assets to prop up corporate cash flow — to argue for the rewriting of the securities laws.

We both know that if the plaintiffs' bar somehow can persuade the Supreme Court (and I doubt the justices will) to adopt so-called "scheme liability," plaintiffs will be able to extract millions, if not billions, from innocent investment banks, accountants, vendors and maybe even law firms (yikes!) whenever a company's stock drops. As a securities defense lawyer, the creation of amorphous "scheme liability" may be good for my narrow practice, but it will be a disaster for our economy, especially in New York. I'm sure the Mayor of London is rooting for you.

Let's review some history. The plaintiffs' bar was never happy with the Supreme Court's decision in *Central Bank,* which held that rule 10b-5 imposes liability only on defendants who themselves make a false statement relied on by investors. The Court's ruling was based on a careful reading of the language of Section 10(b) — the statute that gave the SEC authority to create rule 10b-5 — and the dangerous "ripple effects" of imposing "ad hoc" liability on third parties. After *Central Bank*, the plaintiffs bar asked Congress to create so-called "aiding and abetting" liability, but Congress said no, granting the authority to sue for "aiding and abetting" only to the SEC in the Private Securities Litigation Reform Act of 1995 ("PSLRA"). The PSLRA, as you'll remember, passed with the support of many Democrats, including Ted Kennedy.

After this, the ever-resourceful plaintiffs bar dreamed up "scheme liability," little more than a new name for "aiding and abetting" liability for private plaintiffs. In a few cases involving massive investor losses, most notably *Enron*, the plaintiffs' bar managed to convince a few sympathetic federal judges to accept "scheme liability," and thereby rewrite the securities laws. Ultimately, the Fifth Circuit reversed the *Enron* district judge, but only after several Wall Street banks had paid billions in settlements to avoid the risk of a trial in which Bill Lerach likely would have asked a jury to "punish" those banks for the sins of Enron's corrupt executives. (As you and I both know, virtually all securities class action settle because defendants can't run the risk of a runaway jury in cases in which plaintiffs are seeking billions of dollars in damages.)

Sean, if Congress originally intended to impose "scheme liability" on third parties, such as banks, why did it take almost 70 years for the plaintiffs' bar to discover this "theory?" The bottom line is that Congress writes the laws in our democracy, and if "scheme liability" is good policy (and, it's not), then Congress is where the battle should be fought, not in the courts. In 1995, Congress decided that the SEC (and the SEC alone) should have the power to prosecute banks that aid and abet securities fraud. Congress clearly did not want to give the plaintiffs bar the enormous leverage of an open-ended theory of liability to extract huge settlements from the supposedly "deep pockets" of those who deal with public companies.

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DEBATING SCHEME LIABILITY

Continued from page 9.

Sean Coffey

Thanks Bob for your concession that Bank A's conduct in my hypothetical was "troubling." That had to hurt. The question that investors would like to have you (and the Chamber of Commerce) answer is: do you think Bank A should get a pass for what it did in the (not so) hypothetical? Or is Bank A an "innocent" third party that should be beyond the reach of defrauded investors?

Your response suffers from several flaws. Most notably, it fails to acknowledge all of the hoops that an investor would have to jump through to obtain a recovery from our hypothetical Bank A even if "scheme liability" were a viable theory — hoops that give comfort even to the most flagrant wrongdoers.

Thanks to the PSLRA, before investors can recover a dime for their losses due to securities fraud they must file a complaint significantly more detailed than those required in typical civil actions. They have to allege a "cogent and compelling" portrait of an intent to commit fraud, and link specific stock drops to the fraud itself, all without the benefit of any discovery from the defendant's files (a right that civil litigants get in every other kind of case). Furthermore, if the case survives a motion to dismiss and a jury eventually concludes that investors proved their case, the award against any particular defendant is reduced to the share of the blame the jury concludes the defendant deserves.

These and other mechanisms were put in place a dozen years ago to reduce frivolous securities litigation and the threat of "runaway" verdicts against honest business people. And guess what? It worked. Filings are down; dismissals are up; and the cases where investors get real money back have names like *WorldCom, Cendant, Enron, Nortel,* etc.

Bob Giuffra: "If Congress originally intended to impose 'scheme liability' on third parties, such as banks, why did it take almost 70 years for the plaintiffs' bar to discover this 'theory?"

As for the history lesson, please recall that before the 1994 *Central Bank* decision (which, based on your description of the holding, I think you ought to re-read), circuit courts covering virtually the entire country believed that investors could bring aiding and abetting claims, so the need to invoke "scheme liability" was absent. "Scheme liability" isn't some "new" fad cooked up by the plaintiffs bar since 1994; Rule 10b-5 (including the scheme provisions of subsections (a) and (c)) was put in place by the SEC in 1942.

Let me put it right out on the table. "Scheme liability" is invoked more these days partly because more third parties feel emboldened to participate in such schemes. They feel they can make money doing shady things they wouldn't do if there were a chance they'd have to pay for their transgressions. In my world, Bank A would be sufficiently concerned about "scheme liability" that it would think twice about papering a loan as a bogus purchase so a company could cook its books.

But the SEC can go after them, you say? Please. I'm sure you would be comfortable having the present SEC leadership "protecting" investors. My clients aren't (although they, like me, admire the career, rank and file enforcement staff).

I happen to believe that the vast majority of corporate officers, lawyers, bankers, and yes, even auditors try to earn their keep honestly and act in an ethical manner. The conduct that scheme liability seeks to address is that (hopefully) very narrow band of conduct that is by its nature deceptive and fraudulent — fabricating loans, setting up bogus round-trip revenue deals, and the like. If corporate America feels that outlawing that type of conduct would have a material adverse effect on how it does business, then maybe I ought to move to London.

Bob Giuffra

Sean, you're right that the PSLRA has done much to improve securities class actions. Now, plaintiffs lawyers have real clients — at least in the big cases like *Enron*. And, post-PSLRA, it's harder to bring a strike suit based on flimsy allegations. But too many frivolous cases still get past motions to dismiss, and defendants still pay millions to settle weak cases.

You gloss over my point that Congress makes the laws, not the courts. In the PSLRA, Congress expressly refused to enact "aiding and abetting" liability. Having lost in Congress, the plaintiffs' bar now wants the Supreme Court to rewrite Section 10(b) to create "scheme liability," which is — sorry — just another version of "aiding and abetting" liability. There's no way around that.

In reciting some of the elements of a Section 10(b) violation, you studiously ignore the requirement that investors must rely on the allegedly false statement to state a legal claim. In your hypothetical, the company (not Bank A) made the allegedly false statements to investors; investors can sue the company or perhaps its accountants for any false statements they made.

The plaintiffs bar wants to use "scheme liability" to write the "reliance requirement" out of Section 10(b). You want to say that if the issuer made a misstatement to the market as part of the "scheme" (and the investors relied on the statement through the so-called fraud on the market presumption), then the bank is responsible for this misstatement as a co-schemer, even though the bank didn't make the statement. This sounds a lot like conspiracy, and Congress has refused to turn Section 10(b) into a conspiracy law. Sorry.

Our debate is not about Bank A. It's about whether the plaintiffs bar should collect big fees by suing innocent third parties. And it's about whether those innocent third parties should be forced to pay millions simply because they did business with a public company that suffered a big stock drop.

Sean Coffey

Bob, I take your unremarkable point that Congress makes laws, not the courts, but please remember also that Congress empowered the SEC to promulgate rules to effectuate the purposes of Section 10(b), and it did so over 60 years ago with Rule 10b-5. That rule — which the PSLRA did not disturb when it overhauled the securities laws in 1995 — has three subsections, only one of which (subsection (b)) deals with false statements. As any good strict constructionist should agree, the other two subsections (which deal with scheme and deceptive practices, not statements) must mean something. That is what investors are relying on in pressing "scheme liability" claims. You haven't gotten around to dealing with that yet and I invite you to do so.

Finally, I agree that there is still too much frivolous litigation in this area. But my observation is that the majority of it is practiced by defendants who have their lawyers deny the obvious, file every motion that can be filed regardless of merit and engage in every dilatory tactic that can be made. (Not you though, Bob.)

Bob Giuffra

Sean, the SEC can't adopt a regulation that exceeds the statutory language of Section 10(b), and the statute says nothing — not a word— about "scheme liability." And the SEC hasn't interpreted Section 10(b), or even

Sean Coffey: "Let me put it right out on the table. 'Scheme liability' is invoked more these days partly because more third parties feel emboldened to participate in such schemes. They feel they can make money doing shady things they wouldn't do if there were a chance they'd have to pay for their transgressions."

Rule 10b-5, to permit the sort of amorphous "scheme liability" that plaintiffs' lawyers want to use to leverage big settlements from innocent third parties. And remember, the Supreme Court in *Central Bank* rejected as inconsistent with the statutory text the SEC's then-reading of Section 10(b) to permit "aiding and abetting" liability, and Congress refused to create such liability in the PSLRA.

Our dispute is all about the standards governing pre-trial motions. We both know that almost every case settles if defense motions are denied. Armed with the weapon of open-ended "scheme liability," plaintiffs lawyers easily could survive such motions and then use trumped-up damages theories to bludgeon banks and other third parties into multi-million and, as in *Enron*, even billion dollar settlements.

There's no doubt that the present system benefits lawyers, not investors. We spend millions of dollars on litigation, and even in the most egregious cases, investors recover only a small fraction of their losses. Almost every public company faces business risks that even the most diligent banker may not spot. And, yes, sometimes corporate executives are crooks who deceive their bankers. But turning banks into insurers for their clients' losses will weaken the U.S. capital markets.

Sean Coffey

Yikes, Bob. Let me focus quickly on your statement that the SEC hasn't interpreted the law the way I have described. That's wrong. The SEC is on record stating its view that private investors can assert "scheme liability" claims, and even filed a "friend of the court" brief laying out the basis for "scheme liability" in a recent 9th Circuit case. In fact, the SEC voted to submit a brief in support of "scheme liability" in *Stoneridge*, but the Justice Department's Solicitor General (who has final say on whether to file briefs for the government) nixed the idea. Remarkably, there have been reports that the President took the unusual step of reaching out to tell the SG not to file the brief, but I'm confident this White House doesn't interfere with internal DOJ workings, aren't you Bob?

Bob Giuffra

Sean, I was referring to the completely open-ended theory of "scheme liability" whereby even the making of a plain vanilla loan can be the basis for liability. In the Ninth Circuit case, the SEC advocated some limits, saying that "scheme liability" shouldn't apply just because a bank makes a loan knowing that a company will use the proceeds to keep a fraud afloat. In regard to the *amicus* brief in *Stoneridge*, let's wait and see, but hopefully the SG will come down on the side of the U.S. capital markets and not the plaintiffs bar.

It's been fun, Sean. See you in court.

GAO Report Finds SEC Routinely Mothballs Fraud Investigations

By Benjamin Galdston

According to its own mission statement, the U.S. Securities and Exchange Commission ("SEC") is the top law enforcement agency responsible to "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." However, under the leadership of Christopher Cox — the former Republican congressman and author of the Private Securities Litigation Reform Act of 1995 — the SEC has come under fire recently for bowing to political pressures and not doing enough to protect investors. For example, although the SEC initially recommended filing a brief with the Supreme Court in support of investors seeking to hold liable silent co-conspirators who participate in fraudulent schemes, the Solicitor General ultimately decided to side with corporate interests. (See "To Scheme or Not to Scheme…" on page 1.) Coming on the heels of this failure, the U.S. Government Accountability Office ("GAO") published the findings of its review of the SEC's Division of Enforcement, which is charged with investigating securities fraud and other financial crimes, recommending civil enforcement actions when appropriate, and negotiating settlements on behalf of the SEC. The revelations of the GAO report are also shocking, revealing a back-log of unresolved investigations — most over two years old and one-third over five years old.

Between November 2006 and July 2007, the GAO evaluated the Enforcement Division's (1) investigation planning and information systems and (2) oversight of the SEC's Fair Fund program. The Fair Fund program is the mechanism by which the SEC compensates investors harmed by securities fraud by combining monetary penalties and disgorgements obtained from violators into a single fund and then distributing the proceeds to claimants. In recent years, the SEC has secured record recoveries from companies and senior officers. However, the GAO report revealed that the SEC's Fair Fund has distributed only $1.8 billion of the $8.4 billion in corporate penalties collected. Equally troubling, the GAO report appears to bolster long-standing suspicions that political considerations have propelled certain investigations forward while others languish in inactivity for years. The GAO study found that two-thirds of the pending investigations had been initiated two or more years ago and that one-third of the investigations were more than five years old. The GAO recommended, among other things, that the SEC Chairman and the SEC (1) establish written policies and assessment criteria to better evaluate investigations at the outset, (2) develop expedited processes for closing investigations, and (3) overhaul the Fair Fund program to more efficiently compensate injured investors.

In a letter responding to the GAO report, Chairman Cox conceded that the SEC's system for planning, tracking and closing cases is plagued with "a number of weaknesses" and requires "improved systems and procedures…to more capably manage its operations" and pledged to implement each of the GAO's recommendations. Whether the SEC's actions live up to its promises remains to be seen. If the SEC's recent failure to file an *amicus* brief with the Supreme Court on behalf of investors is any indication of its commitment to protecting investors, we may be waiting a while.

Benjamin Galdston is an associate in BLB&G's California office and co-editor of the Advocate. *He can be reached at beng@blbglaw.com.*

Contact Us

We welcome input from our readers. If you have comments or suggestions, please contact Editors **Hannah Greenwald** in our New York office at 212-554-1400 / hannah@blbglaw.com or **Benjamin Galdston** in our California office at 888-924-1888 / beng@blbglaw.com.

If you would like more information about our firm, please visit our website at

www.blbglaw.com

Editors: Benjamin Galdston and Hannah Greenwald
Marketing Director: Alexander Coxe
"Eye" Editor: Laura Gundersheim
Contributors: Max Berger, Sean Coffey, Benjamin Galdston, Robert Giuffra and Noam Mandel.

BLB&G
BERNSTEIN LITOWITZ BERGER & GROSSMANN LLP

800-380-8496
E-mail: blbg@blbglaw.com

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

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

Louisiana
2727 Prytania Street, Suite 14
New Orleans, LA 70130
Tel: 504-899-2339

New Jersey
220 St. Paul Street
Westfield, NJ 07090
Tel: 908-928-1700