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SECURITIES FRAUD MONITOR

B E R M A N D E V A L E R I O P E A S E T A B A C C O B U R T & P U C I L L O

Scheme Liability Case to Address Pivotal Questions

The critical concept of “scheme liability” will be front and center when the U.S. Supreme Court hears arguments this fall on what may be the most important securities class action question to reach the high court in decades.

The issue is whether shareholders can recover damages from third parties who scheme with a defendant company to engineer a fraud. In the case at hand, cable television provider Charter Communications allegedly inflated its revenue by \$17 million. The plaintiffs, StoneRidge Investment Partners, claim Motorola and Scientific-Atlanta were willing partners in the fraud.

According to the plaintiffs, Motorola and Scientific-Atlanta did more than simply “aid and abet” Charter. This is a crucial distinction. Since the Supreme Court’s 1994 *Central Bank* decision, investors can no longer sue third parties – such as investment bankers, auditors and attorneys – for “merely” aiding and abetting a fraud.

(An aside: We have always puzzled over the use of the word “mere” for aiding and abetting. If you’re aiding in a fraud, shouldn’t you bear some responsibility for it?)

In *StoneRidge*, a federal district court and the U.S. Court of Appeals for the Eighth Circuit dismissed the investors’ claims, arguing that Motorola and Scientific-Atlanta did not themselves violate any securities laws. According to both rulings, the two companies did aid and abet Charter Communications,

but are protected from lawsuits because they did not make public statements related to the fraudulent activity.

Similarly, a recent decision by the U.S. Court of Appeals for the Fifth Circuit ruled against former Enron shareholders who had successfully sued three investment banks in district court. “Presuming plaintiffs’ allegations to be true, Enron committed fraud by misstating its accounts, but the banks only aided and abetted that fraud by engaging in transactions to make it more plausible,” the appeals judges wrote. “They owed no duty to Enron’s shareholders.”

The Supreme Court has not yet decided whether it will hear the Enron case.

According to the StoneRidge complaint, Charter bartered with Motorola

and Scientific-Atlanta, agreeing to pay the vendors inflated prices for cable boxes, with the inflated portion to be returned to Charter. Charter allegedly recognized the amounts as revenue, simultaneously capitalizing the equipment costs to inflate revenue.

A ruling in favor of Motorola and Scientific-Atlanta would absolve those who have knowingly created fraudulent transactions for the sole purpose of inflating a public company’s reported revenue and earnings. It’s almost unthinkable that the court would allow companies to behave so badly without any accountability.

In some of the worst examples of fraud – Enron, for one – the company itself has gone bankrupt, leaving no

Continued on page 5

Tellabs Decision Disappoints Defendants

While the press has been reporting the Supreme Court’s decision in *Tellabs, Inc. v. Makor* as a stirring victory for defendants, that is far from the case. Plaintiffs can take heart that Justice Ruth Bader Ginsburg has set a reasonable standard for review on motions to dismiss. As practitioners, we have met this standard for years.

The work we do to investigate allegations of fraud prior to filing, and to detail the relevant facts in the complaints we file, will continue to provide courts with good cause to sustain them.

It is true that the 7th Circuit’s decision sustaining the plaintiffs’ complaint was reversed by the Supreme Court, but the importance of the decision lies in the standard the Supreme Court prescribed for reviewing motions to dismiss in securities fraud cases. That standard is essentially the same as has been applied in the 1st, 2nd and 3rd circuits for decades, and it is more favorable than the standards that have been applied in many other circuits in recent years.

Continued on page 2

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Berman DeValerio Pease Tabacco Burt & Pucillo prosecutes class actions nationwide on behalf of institutions and individuals, chiefly victims of securities fraud and antitrust law violations. The firm, which was founded in 1982, has offices in Boston, San Francisco and West Palm Beach. In addition to conducting litigation, the firm provides securities fraud monitoring, evaluation and advisory services to public pension funds and other institutional investors.

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Tellabs Decision

Continued from page 1

The law has been that securities fraud plaintiffs must plead their complaints to include specific facts which support a strong inference that the defendants knowingly or extremely recklessly (also referred to as "with *scienter*") made false statements about their business. This 2nd Circuit standard was codified in the PSLRA passed in 1995.

In *Tellabs*, the 7th Circuit reinstated the plaintiff's complaint, which had been dismissed by the district court. The 7th Circuit held that courts should examine the entirety of the allegations in the complaint to see if all those allegations together would lead a reasonable person to infer that the defendants acted knowingly. Most practitioners would agree that this relaxed the pleading requirement below the bar Congress set when it passed the PSLRA.

The Supreme Court decided that this was too generous a standard to apply, and that the requirement to show a "strong inference" required more of plaintiffs. Plaintiffs cannot merely show that an inference of knowing illegal conduct is plausible or reasonable. It must be cogent and at least as compelling as any opposing inference of innocent intent the defendants might suggest.

Defendants were asking the Supreme Court to do far more to protect them from being held liable. At oral argument, the defendants said that the Supreme Court should "force the plaintiffs to demonstrate that innocent explanations can be set aside" and, "do away with reading allegations in the light most favorable to plaintiff." Most disturbing was that the United States

filed an *amicus* brief on behalf of the defendants and stood up in court to make these arguments alongside defendants in the Supreme Court. The Bush administration has vigorously taken up the cause of securities fraud defendants.

The Supreme Court did not buy it. Justice Ginsburg pointedly rejected the defendants' and the administration's arguments. She held: (1) "courts must . . . accept all factual allegations in the complaint as true"; (2) "courts must consider the complaint in its entirety" and may not, as some circuits have done, scrutinize and reject allegations in isolation; and (3) while courts "must take into account plausible opposing inferences" raised by defendants, plaintiffs' complaint will survive "if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged."

We can meet this standard and have done so for years. Indeed, in many circuits a complaint that was likely to be dismissed will now have a much better chance of being sustained. When the *Tellabs* complaint is reconsidered in the courts below, it will likely survive, if the summary of the allegations reported by Justices Ginsburg and Stevens is accepted by the courts as true, as required.

Justice Ginsburg's opinion was joined by Chief Justice Roberts and Justices Kennedy, Souter, Thomas and Breyer. Justices Scalia and Alito filed opinions concurring in the judgment, for an 8-1 majority. Justice Stevens dissented, stating that he thought the plaintiffs' complaint was more than adequate and the 7th Circuit's standard of review was proper. ■

Peter A. Pease

A Report Card On SEC Chief Christopher Cox

Two years ago this August, Christopher Cox took the helm of the Securities and Exchange Commission. This spring, Cox told reporters that he and his agency have served as “relentless advocates for investors” who “absolutely” have put shareholders first.

We know relentless advocates. We work with relentless advocates. And Mr. Chairman, you’re no relentless advocate.

To be honest, Cox has proved better than expected in some areas, given his record of pandering to business while in Congress. Yet despite all protestations to the contrary, the agency he heads has, by and large, served mainly to advance the corporate agenda – particularly over the last six months.

We are not alone in this view. In May, two state attorneys general wrote a letter to House Financial Services Committee Chairman Barney Frank and others criticizing the SEC. “We are only five years removed from the scandals of Enron and WorldCom and yet many have forgotten the lessons those cases have taught,” they wrote.

To coincide with Cox’s anniversary, we have put together a topical report card to rate the chairman’s investor advocacy.

Tellabs Inc. Grade: F

This recently decided Supreme Court case (see related article on page 1) centered on shareholders’ abilities to successfully pursue securities fraud

lawsuits. Amazingly, the SEC filed an *amicus* brief on behalf of Tellabs Inc., the defendant. Cox was quoted as saying that a stricter pleading standard is one mechanism to reduce “fraudulent lawsuits” filed by “professional plaintiffs.” Luckily for investors, the Supreme Court’s ruling appears balanced.

Charter Communications Grade: B-

The SEC might have received a high grade for its response to this scheme liability case, which the U.S. Supreme Court is expected to take up this fall. The SEC apparently favored filing an *amicus* brief on behalf of investors in this pivotal case that could decide whether third parties can be held liable for the securities violations of another company.

But the deadline for *amicus* brief filings came and went without an SEC brief. According to media reports, the Bush Administration may have stopped

the SEC from going on record. (The President believes these cases are for regulators—not the courts—to decide.)

We could give Cox the benefit of the doubt and say that he really did want to side with investors. On the other hand, he may have gotten some convenient cover when the Bush Administration nixed his brief.

No matter the background to the story, Cox did investors no favors. Either he wasn’t serious about the need to weigh in on their behalf or he didn’t fight hard enough to make it happen.

Executive Compensation Reforms Grade: C

The original idea here was a good one: improve transparency on executive salaries and perks by requiring companies to report them “in plain English.” But the SEC approved a revision to allow companies to disclose stock and

Continued on page 4



Christopher Cox

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“Miss Dugan, will you send someone in here who can distinguish right from wrong?”

SEC Report Card

Continued from page 3

option compensation for top executives when the cost is recognized – not when the award was made.

Who sought the change? The U.S. Chamber of Commerce. Why? Because it lets companies spread expenses over several years. Take this example, courtesy of Bloomberg, for Brookfield Homes Corp. After the change, the company said CEO Ian Cockwell received negative pay of \$2.3 million in 2006, despite receiving salary, bonus and other compensation totaling \$789,997.

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Setting Fines Grade: D

A new policy under Cox's watch restricts the ability of SEC staff to impose fines on companies. SEC attorneys must now obtain authorization from the five commissioners before they can negotiate fines with companies. Prior to the change, the attorneys could reach settlements with companies and then seek a vote from the commissioners. Many expect lower fines will result, in part for partisan reasons. All of the SEC

commissioners are political appointees. Three are Republicans; two are Democrats.

In April, Roel Campos, the senior Democrat commissioner, suggested that the new policy will "disrupt a process that has served the commission and investors well for many years."

Arbitration Grade: F

This spring, the SEC announced it was weighing a new policy to resolve shareholder grievances through arbitration, rather than lawsuits. In May, Cox denied in a Senate hearing that any new arbitration rule was pending. But he did later say that the SEC will consider the recommendations of several panels that are exploring the proposal. One key proponent of arbitration: the Committee on Capital Markets Regulation, also known as the Paulson Committee.

A new arbitration policy would be a terrific benefit for corporations – and an enormous detriment to investors. Let's hope Cox was just floating a trial balloon.

Shareholder Nominations Grade: D

The SEC narrowly endorsed a proposal to make it easier for shareholders to nominate candidates to company boards. But the SEC wants the threshold of ownership to be at least 5% of shares – too great a percentage by many accounts. According to critics, only hedge funds have ownership stakes high enough to benefit from the plan.

Richard Ferlauto, director of pension investment policy at the American Federation of State, County and Municipal Employees, has called the proposal "totally irresponsible."

Tenet Healthcare Corp. Grade: C-

The SEC accused the nation's largest publicly traded hospital chain of concealing a Medicare scheme to pump up earnings and deceive investors. To settle the charges, Tenet agreed in April to pay a civil penalty of \$10 million.

At the same time, however, the SEC offered Tenet some future protections. According to Bloomberg, the SEC waived a rule that says companies that commit fraud lose a legal shield, making it harder for shareholders to

A new arbitration policy would be a terrific benefit for corporations – and an enormous detriment to investors.

file lawsuits. Cox said the waiver was granted because the company has been rehabilitating itself over the course of the investigation.

Options Backdating B+ (and Greatest Improvement)

Cox didn't quite get the options backdating scandal when it first broke. In public comments, he treated the backdating games as simple disclosure issues, pooh-poohing the notion that backdating was inherently wrong.

He has since changed his tune.

In June, the SEC announced settlements with two California technology companies to resolve backdating-related charges. In a written statement, Cox said the SEC "will use all the weapons in our arsenal, including significant corporate penalties, to protect investors and combat fraudulent stock option backdating."

About 140 companies are under federal investigation for options backdating. ■

Trustees Grapple with Socially Responsible Investing

The Fire and Police Pension Association of Colorado recently asked San Francisco Partner Joseph J. Tabacco, Jr., to discuss the challenges of squaring fiduciary obligations with calls for socially responsible investing and divestment. The following article was adapted from his August presentation.

In the emotionally charged debate over socially responsible investing, middle ground is hard to find – especially when it comes to laws requiring public pension funds to sell assets tied to genocide or terrorism.

To advocates, divesting from companies that do business with Sudan, Iran or Syria is nothing less than a “moral imperative.” To opponents, forced divestment undermines their highest duty as a fiduciary: to make prudent financial decisions based solely on the interests of pension plan participants.

Both sides make valid points. But from a practical standpoint there is

no contest. As divestment sweeps the country, public pension funds are scrambling to protect their investment returns and salvage their autonomy.

The idea of socially responsible investing in financial markets goes back at least as far as the early 1900s, when the Methodist Church spurned stocks related to alcohol and gambling. It came of age in the 1980s, with the international campaign to turn South Africa’s apartheid regime into a financial pariah.

Individuals today can buy mutual funds that screen out cigarette makers, polluters and other companies deemed undesirable. Socially responsible investing can also funnel investments into companies that may offer a social benefit – dedicating a portion of a fund’s portfolio to companies that create local jobs, for example.

The most successful recent divest-

ment campaign has targeted war-torn Sudan, where the United Nations estimates as many as 450,000 people have been killed and up to 2.5 million have been displaced. As of early August, 19 states had adopted policies to divest from Sudan, while another 19 had initiated divestment campaigns, according to the Sudan Divestment Task Force.

Though they often hail from different parts of the political spectrum, the activists behind divestment from Sudan and Iran – the next country targeted for action – offer the same simple logic when arguing on behalf of their causes.

“It is immoral to own shares in companies that now willingly engage in commerce with a regime that is guilty of ongoing genocide,” says Sudan activist Eric Reeves.

Missouri State Treasurer Sarah Steelman, who advocates so-called

Continued on page 6

Scheme Liability

Continued from page 1

financial remedy for investors. In those cases, it’s critical that other willing participants in the fraud be held accountable, so investors have some opportunity to reclaim the money that was taken from them.

Fears that the Supreme Court would make securities cases harder for plaintiffs never materialized in the recent *Tellabs* decision, which was written by Justice Ruth Bader Ginsburg (see related article). If anything, the Supreme Court helped investors in that case.

The *Tellabs* ruling gives us reason to be optimistic for StoneRidge. If Justice Ginsburg takes the lead on Charter,

we are confident it will be a sensible decision.

The political wrangling behind the scenes has been as interesting as the case itself. The Securities & Exchange Commission had voted to submit an *amicus* brief on behalf of the plaintiffs, but the Bush Administration objected and the deadline passed without comment from the SEC.

In August, the U.S. Solicitor General filed an *amicus* brief in support of defendants.

In other words, the principal government enforcer of securities laws tried to side with investors and the Solicitor General refused to allow it and then took the opposite position. A bipartisan group of former SEC officials was outraged enough to ask the court to

let them file an *amicus* brief after the deadline.

Former SEC Chairmen William H. Donaldson and Arthur Levitt and former Commissioner Harvey J. Goldschmid called the case “critical” for investors.

“Holding liable wrongdoers who actively engage in fraudulent contact that lacks a legitimate business purpose does not hinder, but rather enhances, the integrity of our markets and our economy,” their lawyers wrote. “We believe that the integrity of our markets is their strength.”

The SEC and its former leaders obviously understand the importance of scheme liability in securities cases. Let’s cross our fingers that the Supreme Court justices understand, too. ■

Investing

Continued from page 5

"anti-terror" investment screens, says that "public tax dollars should not be used to finance terrorism anywhere in the world."

The effect of Sudan divestment on public pension funds pales compared with the anti-terror initiatives now gathering momentum around the country. Because Sudan's economy is small, fewer than 25 companies are on activists' hit list.

Critics of divestment must resort to more nuanced arguments and risk running a gantlet of bad press if they oppose popular initiatives outright. Testifying about a socially responsible investing bill in Texas, Keith Brainard of the National Association of State Retirement Administrators focused on several key issues. (The Texas legislation illustrates the challenges faced by public funds; it passed unanimously.)

Pension funds are held in trust.

Socially responsible investing may conflict with trustees' "duty of loyalty," which requires them to act as a prudent expert in the exclusive interests of plan participants. That, in turn, means weighing potential risks and potential returns and choosing the investment mix most likely to fulfill the trust's obligations.

Investors lose leverage when they sell. Divestment is a one-time act. Funds such as the California Public Employees' Retirement System believe a policy of constructive engagement gives them a better chance to effect change.

Divestment costs beneficiaries money. It costs money to establish a mechanism to weed out offending securities. It costs money to sell targeted stocks and replace them with others. Finally, it may cost money, year in and year out, in lost returns if the replacement stocks do not perform as well as the divested shares.

Divestment may not be effective.

Other investors will almost certainly purchase divested shares.

So what should pension funds do? There are some steps that make sense.

In the early stages of a divestment campaign, for example, funds can work to add language to any pending legislation to expressly state that trustees' actions must be consistent with their fiduciary duties. Funds can also work to keep control of the list of impacted investments, said fiduciary counsel Ian Lanoff in a recent teleconference on divestment sponsored by the Council of Institutional Investors.

According to Lanoff, funds should ask two key questions once a law is enacted:

- Is it prudent to hold the investments on the list?
- Is it imprudent to sell the investments on the list?

When conducting their analysis, fiduciaries should evaluate the economic characteristics of each scrutinized investment – chiefly its performance potential and volatility – and the availability of substitute investments with similar characteristics. They should carefully document their analysis.

Though fiduciaries must restrict themselves to an economic analysis, they may have some wiggle room when asking these questions. That is because some funds have decided to expand their risk analysis to include factors

such as risks from litigation, regulatory or legislative actions and policy actions taken by the institutional investor community. In other words, the movement to divest from companies tied to a certain country could actually add to the risk of holding onto those stocks.

Fiduciaries may consider so-called collateral benefits, such as social good, if another investment with similar risk-return characteristics is available, according to a 1994 Department of Labor Interpretive Bulletin. Of course, that does not factor in transaction costs associated with divestment.

Trustees may have an obligation to oppose divestment if they cannot keep control of the list and guarantee consistency with their fiduciary duty. But in the end, they also must consider the costs of undertaking a legal battle with the government, which could end up costing considerably more than divestment itself.

Funds also should be wary about supporting any divestment law, no matter how politically popular, because it sets a bad precedent. Though Sudan divestment may carry a small price tag, the impact of divestment from Iran is potentially huge. And Iran may be just the beginning.

In a report released just this August, the Center for Retirement Research at Boston College cautions against investing for social or environmental reasons, calling a broad-based divestiture movement a "slippery slope" that "will definitely hurt returns."

"The issue remains whether pension funds are an appropriate vehicle for implementing [foreign] policy. The answer seems unquestionably 'no,'" the study concludes. "Encouraging public pension fund trustees to take 'their eyes off the prize' of the maximum return for any given level of risk is asking for trouble." ■