CHADBOURNE & PARKE LLP

CHADBOURNE
& PARKE LLP

SECURITIES LITIGATION AND ENFORCEMENT NewsWire

April 2005

With a grateful and laudatory nod to Jerome Frank — a former Chadbourne partner, who became an SEC Commissioner in 1937 and then the SEC Chairman from 1939 to 1941, and who thereafter became a distinguished Second Circuit Judge at the height of his career — we take on his role and tradition of "iconoclastic reformer" of regulatory initiatives and measures dealing with high finance but that unnecessarily undermine or denigrate corporate life and the human spirit.

IN THIS ISSUE

2 Jerome Frank: Chadbourne Partner

4 Criminal Certification Under Sarbanes-Oxley Not Unconstitutionally Vague

7 Can the SEC Escrow "Extraordinary Payment"?

9 Can the SEC Require Disgorgement of Base Salary?

10 Employee Indemnification Agreements — the SEC's Newest Enemy

12 A Notion of "Collective Scienter"

14 SEC Files Amicus Briefs in Private Securities Fraud Actions Challenging Traditional Notions of Reliance and Causation

15 Secondary Actor Liability in Private Securities Actions in the Wake of *Central Bank*

18 SEC and Spitzer Investigations into "Non-Traditional" Insurance Products

20 The Supreme Court's Decision in *United States v. Booker* Opens the Door to Fairer Sentences in White Collar Cases

21 Companies Should Maintain Effective Compliance and Ethics Programs After the *Booker* and *Fanfan* Decisions

With this inaugural issue, Chadbourne & Parke LLP formally introduces its Securities Litigation & Regulatory Enforcement Practice Group. Although Chadbourne has been handling complex securities litigation cases for the last half century and even though this new group has been litigating some of the high profile securities cases currently pending in the United States for the last two and one-half years, we believe it is time to officially present our group of experienced lawyers, dedicated to representing all sectors of the securities industry and tracking important developments in securities litigation and regulation. As an organized group, we can best serve the needs of our clients and anyone facing complex securities litigation issues.

Over the last two and one-half years, the lawyers in this group have been aggressively defending clients against governmental law enforcement proceedings, whether by the United States Securities and Exchange Commission ("SEC"), the Department of Justice ("DOJ"), the Commodities Futures Trading Commission ("CFTC"), the New York Stock Exchange ("NYSE") or the National Association Securities Dealers ("NASD"). Our group has filed briefs in various courts taking on / *continued page 2*

the high profile, complex financial and regulatory issues of the day. For example, we have challenged the propriety and constitutionality of some of the actions taken by these government regulators — actions which to date have sadly become almost routine law enforcement practices, but which remain unchallenged — such as asset freezes, contempts and government overreaching in parallel law enforcement proceedings. We have also challenged the judicial power of the United States District Courts to administer some of the remedies frequently sought by these government agencies, including asset freezes and contempts. As a result, we have begun to be recognized by our clients and by members of the securities bar, both prosecutors and defenders, as iconoclastic reformers, or "out of the box" thinkers. Indeed, in one case, after a long battle in federal court, our lawyers defeated a $150 million asset freeze imposed by the SEC on a CEO — the first such defeat ever suffered by the SEC's Enforcement Division in its long history of securities enforcement. In another, we have challenged the constitutionality of the newly adopted criminal certification provisions in the new Sarbanes-Oxley Act. Although the District Court ultimately decided this issue against our clients, we will continue to look for opportunities to press this issue, since it was, in our view, wrongly decided and the court failed to address several of the main arguments.

Our group's client representation and expertise covers the spectrum of individuals and entities subject to securities litigation, enforcement and regulation, including officers and directors of public companies, boards of directors, audit committees, accountants, lawyers, investment banks, broker-dealers, investment companies, investment advisors, and hedge funds. We engage in internal investigations on behalf of corporate clients. We defend class actions and derivative suits. We also defend against SEC and CFTC enforcement proceedings, grand jury investigations, and criminal prosecutions brought by various United States Attorneys' Offices across the country. Prior to litigation and as a preventive measure, we also advise clients on how to comply with existing rules, regulations, and laws in an effort to negotiate the terrain of complex securities laws and to avoid becoming a defendant in a securities case.

We intend to publish this *NewsWire* on a quarterly basis in an effort to address recent securities law developments that may be of interest to our clients. We will provide short articles on SEC rules, SEC enforcement proceedings, legislation, current developments in the field of securities litigation, and white collar criminal matters that directly concern the field of securities regulation.

We hope our *NewsWire* will serve as a quick reference for current topical developments. Above all, we want this and future publications to be a service to our existing clients and to prospective clients who may need advice concerning complex securities litigation, regulation, and enforcement issues.

Thomas V. Sjoblom

Jerome Frank: Chadbourne Partner

SEC Commissioner, SEC Chairman, and Second Circuit Court of Appeals Judge

The Honorable Jerome Frank was born in New York City on September 10, 1889 and died on January 13, 1957, hours after writing the last words of his book titled *Not Guilty.*[1]

During his remarkable life, he became a Chadbourne partner, a leader in the "realist movement" in American jurisprudence, a member of President Roosevelt's "brain trust," a Commissioner and then Chairman of the Securities and Exchange Commission, and ultimately a Judge on the United States Court of Appeals for the Second Circuit, to name a few of his accomplishments. Justice William O. Douglas said that Jerome Frank "had no superior when it came to an understanding of the ways of high finance and to an analysis of regulatory measures dealing with it."

Jerome Frank graduated from the University of Chicago in 1909 and entered the University of Chicago Law School, not because he had a great desire to become a lawyer, but because his father — a successful lawyer — wanted him to. He received his law degree in 1912, and joined a Chicago law firm. In 1927, he traveled to New York on business, which led to his decision to leave Chicago and to pursue the practice of law in New York. In 1928, he joined Chadbourne & Parke's predecessor,

Chadbourne, Stanchfield, and Levy, "one of the nation's largest corporate law partnerships."[2]

After the stock market crash of 1929 and the subsequent Depression, Frank began angling for a government position where he could effect public policy. He was interested in then New York Governor Franklin Roosevelt's administration, and he sought a position with the New York State government. Lacking the right connections, he was unsuccessful getting work with the state government. When Roosevelt was elected President, however, Frank wrote to Harvard Professor Felix Frankfurter, who served as the gatekeeper and supplier of young legal talent to the New Deal, and impatiently stated: "I know you know Roosevelt very well. I want to get out of this Wall Street racket, anyhow. The crisis seems to be the equivalent of war and I'd like to join up for the duration." [3]

In 1932, Frank became a government lawyer. He was first hired to be General Counsel of the Agricultural Adjustment Administration, later to become the Department of Agriculture, where he was responsible for bringing a number of promising young attorneys to work for him, including Abe Fortas, Thurmond Arnold, and Adlai Stevenson. According to Abe Fortas, Frank "was the spark plug and the genius of practically every important gathering of active Government officials in those days." [4] In 1935, Frank returned to private practice for a short time.

Jerome N. Frank, Chairman SEC, 1941 (seated center)

In 1937, William O. Douglas, then Chairman of the Securities and Exchange Commission, submitted Frank's name to President Roosevelt for consideration as an SEC Commissioner. At the urging of Douglas, Frank accepted an appointment as a Commissioner with the SEC. Initially, Frank was reluctant to accept the appointment, which paid only $10,000 per year. [5] But he accepted the job as a temporary one, living out of a hotel, and tendering his resignation twice. President Roosevelt refused to accept it.[6]

In 1939, when William O. Douglas was appointed to the United States Supreme Court, Frank was appointed Chairman of the SEC. As Chairman, he presided over a divided Commission during a time when Wall Street, chafing at the bit of the new federal securities laws and regulations, sought to blame the SEC for failing to bring about a new economic recovery. Thus, because his was often the swing vote on the Commission, he frequently determined what the government's policy toward the securities industry and corporate issuers would be.[7] Also, Frank played an instrumental role in pushing legislation through Congress and developing the SEC's new role in regulating investment companies and investment advisors, a phenomenon that developed in the 1930s in response to general financial abuses and large scale conflicts of interest in the management of investment companies. One telling remark about the serious attitude and work ethic Frank brought to his position at the SEC was quoted under his / continued page 4

1 Walter E. Volkomer, *The Passionate Liberal: The Political and Legal Ideas of Jerome Frank*, 19 (Marginus Nijhoff / The Hague)(1970).

2 *Id.* at 8.

3 *Id.* (quoting Columbia University oral History Project).

4 *Id*. at 10 (quoting Letter from Abe Fortas to Richard Rovere, October 25th, 1946. Franklin D. Roosevelt Library).

5 *Id.* at 16.

6 *Time Magazine* at 75 (March 11, 1940).

7 *Id.*

Jerome Frank

continued from page 3

photo on the cover of the *Times Magazine* in 1940: "No rabbits and no silk hats."

In 1941, Roosevelt appointed Frank to the Second Circuit Court of Appeals, the court with some of the pre-eminent legal minds of the day, including Learned Hand (chief judge), Thomas Walter Swan (later chief judge), Augustus Hand, Charles Edward Clark, John Marshall Harlan (later a Supreme Court Justice). The experience that he gained concerning the federal securities laws while working as an SEC Commissioner made him a perfect selection to preside over the many business-related cases tried in and appealed from the United States District Courts in New York. He served on the Second Circuit Court of Appeals, until January 13, 1957, when he died of a heart attack.

Future editions of this *NewsWire* will occasionally make reference to some of Jerome Frank's novel but lofty views, which also always included concern for the human condition. At Chadbourne & Parke, this practice group will seek to emulate his "daring, inventiveness and drive," a phrase used by Abe Fortas in a October 25, 1946 letter, now archived in the Franklin D. Roosevelt library. We will "push the envelope" as far as possible to challenge legal norms of the day, while placing the human spirit and condition foremost in our advocacy. ◎

Criminal Certification Under Sarbanes-Oxley Not Unconstitutionally Vague

by Thomas Sjoblom and Benjamin Ogletree

A federal court recently ruled that a new and controversial criminal certification provision in Section 906 of the Sarbanes-Oxley Act of 2002 is not unconstitutionally vague, and for the first time articulated standards governing its enforcement.

Section 906's Certification Requirement

Section 906 amended Title 18 of the United States Criminal Code by adding a new requirement that periodic (annual and quarterly) reports containing financial statements filed by publicly traded companies with the Securities and Exchange Commission must be accompanied by a written certification signed by the Chief Executive and Chief Financial Officers. Section 906(b) directs the CEO and CFO each to certify that the periodic report fully complies with the Securities and Exchange Act of 1934's reporting requirements, and that the information contained in it "fairly presents, in all material respects," the company's financial condition and results of operations. Under Section 906(c)(1), whoever "certifies" a periodic report "knowing" that it does not comport with all the requirements of Section 906 faces up to a $1 million fine and/or 10 years imprisonment. Under Section 906(c)(2), whoever "*willfully* certifies" a periodic report "knowing" that it does not comport with all the requirements of Section 906 may be punished by up to a $5 million fine and/or 20 years imprisonment.

Chadbourne Challenged the Constitutionality of Section 906

Richard Scrushy, the former CEO of HealthSouth Corporation, is the first corporate executive to be prosecuted under Section 906. Chadbourne, on behalf of Scrushy, moved to dismiss counts charging him under Section 906(c)(2) on the ground that the statute is unconstitutional in several respects. First, Chadbourne argued that Section 906 fails to pass constitutional muster because it imposes criminal liability on corporate officers who certify that their company's periodic reports comply with reporting requirements under the federal securities laws, even though violations of the very reporting requirements themselves are not necessarily criminal acts. Therefore, Chadbourne asserted that Section 906 contravenes the settled legal principle that criminal liability may not be derivatively imposed (*i.e.,* on certifying CEOs and CFOs) unless the underlying primary violation (*i.e.,* preparation of a periodic report that does not comply with applicable reporting requirements) is itself criminal in nature.

Second, Chadbourne argued that Section 906 cannot survive constitutional scrutiny because Sarbanes-Oxley imposes criminal liability on corporate executives who *fail* to certify periodic reports, as Section 906 requires. The statute thus places even a wholly innocent CEO or CFO in the position of being "damned if he does and damned if he doesn't." In other words, under Section 906 a corporate officer is forced either to certify and run the risk of criminal prosecution if the underlying periodic report later is deemed to be inaccurate, or decline to certify (where, for example, a CEO is unable to verify that a periodic report is accurate) and face possible criminal prosecution anyway, irrespective of whether or not his reservations about certifying are justified. Because such laws are constitutionally forbidden, Chadbourne argued that Section 906 is invalid.

Because corporate officers have been signing SEC Form 10-Ks and 10-Qs for decades, the statute fails to give them fair notice of what they now must do, or not do, differently from the last 30 years to comply with the criminal statute and avoid its harsh sanctions.

Third, Chadbourne asserted that Section 906 is unconstitutionally void for vagueness because it fails to define the conduct it prohibits with sufficient particularity to give fair warning of what the statute requires and forbids and places no meaningful, objective limitations on the discretion of law enforcement. Chadbourne contended that Section 906(c)(2) is overly vague because it does not articulate the "evil doing hand" and "evil thinking mind" required by the criminal law. Because corporate officers have been signing (effectively, certifying) SEC Form 10-Ks and 10-Qs for decades, the statute fails to give them fair notice of what they now must do, or not do, differently from the last 30 years to comply with the criminal statute and avoid its harsh sanctions.

Fourth, Chadbourne contended that Section 906 is unconstitutionally indefinite because it does not distinguish between the conduct or mental state that constitutes "certifying" a non-compliant periodic report under Subsection 906(c)(1), as opposed to conduct that constitutes "willfully certifying" such a periodic report under Subsection (c)(2). The mere act of signing periodic reports is, in effect, both a knowing and willful certification. Thus, Chadbourne maintained that it is impossible to discern what action or mental state results in a 10-year prison term under Section 906(c)(1) as distinct from a 20-year prison term under Section 906(c)(2).

Finally, Chadbourne argued that the expressions "fairly presents" and "in all material respects," as used together in Section 906(b) to describe the manner in which certified periodic reports must depict information regarding a company's financial condition and results of operations, render the statute unconstitutionally vague because they are ambiguous, inherently subjective and open-ended in scope. Chadbourne pointed out that the indefiniteness of the phrase "in all material respects" is made even more uncertain because under the SEC's definition of materiality in the context of financial statements, "materiality" must be assessed in light of a variety of highly subjective factors, including the intent of management. See Staff Accounting Bulletin #99 (August 12, 1999). In sum, Chadbourne argued that Section 906(b) fails to articulate any objective criteria for deciding what constitutes a fair presentation of information in all material respects, and thus leaves this determination to the unbridled discretion of law enforcement.

District Court's Ruling

On November 24, 2004, a U.S. District Judge in the Northern District of Alabama upheld the constitutionality of Section 906. In doing so, however, the court focused only on certain arguments advanced by Chadbourne that the statute is void for vagueness and did not address other constitutional challenges that Chadbourne made in support of Scrushy's motion to dismiss. First, the court held that Section 906(c)(2), including "willfully certifies," survives vagueness scrutiny. In describing the conduct proscribed by Section 906(c)(2), the court explained that a corporate officer must certify the accuracy of a periodic report "*willfully* — that is, volitionally, intentionally, and not by accident," with *knowledge* that it does not comply with the requirements of Section 906(b). Adopting the Government's articulation of the standard codified by Section / *continued page 6*

Criminal Certification

continued from page 5

906(c)(2), the court indicated that a defendant

> must not only *know* that the periodic report contains materially false information, he must falsely certify . . . that the report is materially accurate, he must do so *knowing* that such a false certification is forbidden by law, and he must do so with the *specific intent* to violate the law.

The court further determined that although "materiality" and "fairly presents" are elastic and quantitatively uncertain concepts that differ in meaning depending on their usage, both are sufficiently well established in the law to give fair notice of what they require of corporate officers in Section 906(b). The court observed that "[f]or something to be material in a legal sense, whether a word or a deed, it must be of a weight that would affect a reasonable person's decision or action within the relevant context." While the court did not attempt to define "fairly presents," it cited other statutes in which the words appear and noted that "[a]uditors and accountants have long applied this phrase and been held to this principle regarding financial statements."

Due Diligence and Good Faith

At oral argument, the Government articulated the standard of conduct that it believes Section 906 imposes, arguing that "[a]ll the statute asks for from [CEOs] and [CFOs] is due diligence and good faith." In attempting to assuage the court's concern that a mere technical reporting violation could trigger criminal liability under Section 906 (as a strict reading of the statute suggests), the Government insisted that liability attaches only if corporate officers certify "knowing [that] something [in a periodic report] is false and then go ahead and say it's true." Thus, under the Section 906 standard ascribed to by the Government, corporate officers will not face criminal liability for certifying a periodic report that later is determined to be non-compliant if they act in good faith and take reasonable steps to ensure that information contained in the periodic report is materially accurate. Recognizing that "obviously [corporate officers] depend on [their] subordinates," the DOJ specifically described Section 906's due diligence requirement to mean that, "I think if you talk to people, your financial officers, your department heads, you say, have you checked these figures[?] Are you satisfied that they do fairly present the condition of your part of this corporation[?] If the answer is yes, that CEO has discharged his obligation under the statute."

Practical Tips

As a practical matter, this recent articulation of the "due diligence" standard by the DOJ to make prosecutorial decisions should relieve the anxiety of corporate executives if they engage in careful due diligence before certifying periodic reports under Section 906. Such due diligence presumably should include, at minimum:

- Consultation with subordinate officers and managers to make sure that all information in periodic reports is true and accurate; and sub-certifications by them. While this sub-certification will not shield the CEO and CFO from liability, it will serve to mitigate a showing of intent or recklessness;
- Verification that internal accounting controls designed to detect and prevent fraud and malfeasance that might result in errors or misstatements in periodic reports are in place and functioning properly;
- Confirmation from internal and external auditors that no going concerns or other problems with the company's financial condition, or its financial statements exist; and
- Discussion and consultation with the company's general counsel to ensure that he or she has reviewed the periodic report, is satisfied that the information contained in it fairly presents, in all materials respects, the corporation's financial condition and results of operations, and otherwise fully complies with all other applicable reporting requirements. ◎

The court determined that although "materiality" and "fairly presents" are elastic concepts that differ in meaning depending on their usage, both are sufficiently well established in the law to give fair notice of what they require of corporate officers.

Can the SEC Escrow "Extraordinary Payment"?

by James I. Lee

In a case of first impression, *SEC v. Gemstar-TV Guide Int'l, Inc.*,[1] the Court of Appeals for the Ninth Circuit recently held that the Securities and Exchange Commission failed to demonstrate that termination payments made to a corporation's officers constituted "extraordinary payments" under Section 1103 of the Sarbanes-Oxley Act of 2002. The Ninth Circuit based its decision on the SEC's failure to present any evidence as to what would constitute an "*ordinary* payment under the same or similar circumstances."

Sarbanes-Oxley Section 1103

Section 1103, codified in Section 21C(c)(3) of the 1934 Exchange Act, provides that:

> [w]henever, during the course of a lawful investigation involving possible violations of the Federal securities laws by an issuer of publicly traded securities or any of its directors, officers, partners, controlling persons, agents, or employees, it shall appear to the Commission that it is likely that the issuer will make ***extraordinary payments*** (whether compensation or otherwise) to any of the foregoing persons, the Commission may petition a Federal district court for a temporary order requiring the issuer to escrow, subject to court supervision, those payments in an interest-bearing account for 45 days.

Section 1103 also authorizes one additional 45-day extension of the temporary escrow. Further, once the subject of an investigation is charged with a securities violation by the commencement of a civil action, the escrow order remains in effect until the proceedings are concluded. The statute does not, however, define what constitutes an "extraordinary payment."

Relevant Facts

In August 2002, Gemstar-TV Guide International, Inc., a global technology and media company, announced that its revenues and related amortization for 2001 had been overstated by approximately $40 million and that it planned to restructure its management and corporate governance. As part of its restructuring, Gemstar began negotiating termination agreements with its Chief Executive Officer and Chief Operating/Financial Officer. Under the agreements, the CEO was to receive a "termination fee" of $22.4 million, $7 million in unpaid salary, bonuses, and unused vacation time, and 5.2 million shares of restricted stock. The COO/CFO was to receive a termination fee of $6.9 million, $1.2 million in unpaid salary, bonuses, and unused vacation time, 1.1 million shares in common stock, and approximately 350,000 shares in restricted stock. Before these termination agreements were in final form, attorneys for the SEC approached Gemstar to request that the collective termination payments be placed in escrow pending an SEC investigation regarding the overstatement of revenue. The CEO and COO/CFO refused. Later, however, Gemstar informed the CEO and COO/CFO that it would place the termination payments in escrow for six months. Both the CEO and COO/CFO acceded to the six month escrow.

District Court Proceedings

In March 2003, the terminated CEO and COO/CFO filed a complaint in the U.S. District Court for the Central District of California seeking injunctive and declaratory relief to dissolve the escrow. Following a hearing, the district court denied the request for relief. A few months later, the day before the six-month escrow period was set to expire, the SEC filed an application with the district court to have the termination payments placed in a 45-day escrow account pursuant to Section 1103 of the Sarbanes-Oxley Act. The district court granted the SEC's request.

Appeal to the Ninth Circuit

The former CEO and COO/CFO filed an / *continued page 8*

[1] 367 F.3d 1087 (9th Cir. 2004).

"Extraordinary Payments"

continued from page 7

interlocutory appeal to the Court of Appeals for the Ninth Circuit. In its decision, the court noted that, while the SEC is authorized under Sarbanes-Oxley to adopt regulations to define the term "extraordinary payment," it had not done so. Thus, in an exercise in statutory construction, the court turned to "common parlance" of the word "extraordinary" and found that as a comparative adjective, the word could only have meaning in relation to what was "usual" or "ordinary." In this regard, the court found that the record was devoid of any proof of what constituted usual or ordinary payments upon the termination of corporate officers under the same or similar circumstances as in the case at bar. The court found that the extended negotiations over the termination payments, the significant size of the payments and the fact that Gemstar chose to report the terms of the termination agreements (presumably as "material") in a Form 8-K filing, all of which the district court found persuasive, could not be relied upon without evidence that they were out of the ordinary. In so finding, the court stated that termination payments of these types "may be called 'golden parachutes' or 'golden handshakes' in the press, but purple prose is not enough to prove a statutory requirement in court."

The dissenting opinion advocated a definition of "extraordinary" as "a payment made not in the customary or normal pursuit of the regular trade or business of the issuer ***under scrutiny***, but in response to an irregular or abnormal demand of the moment that reasonably appears to have been provoked or motivated by or connected to the possible violations of securities laws that triggered the investigation." The dissenting judge argued that the majority opinion dealt "an unwarranted blow to the public interest and to the Commission's ability adequately to protect that broad interest against the flood of corporate scandals of which Congress and the public has become all too painfully aware in the past few years."

The court stated that termination payments of these types "may be called 'golden parachutes' or 'golden handshakes' in the press, but purple prose is not enough to prove a statutory requirement in court."

Unresolved Issues

The former CEO and COO/CFO had also argued that Section 1103 was unconstitutionally vague and operated in an unconstitutionally retroactive manner. The Court of Appeals, however, declined to rule on those issues leaving open the possibility that Section 1103 might be open to a challenge on those grounds. The court also referred to the SEC's unsuccessful attempt in *SEC v. HealthSouth*,[2] to freeze a defendant's assets under Section 1103, where the U.S. District Court for the Northern District of Alabama noted that the provision was inapplicable as it pertains to situations in which the SEC is investigating the *issuer* and does not apply where only individual defendants are involved.

Rehearing En Banc

The SEC petitioned for and was granted en banc review of the *Gemstar* decision, *SEC v. Yuen*.[3] On review, the SEC argued that only factors relating to the relationship between the corporation and the insider involved (including the circumstances, amount, and purpose of the payment) should be considered in determining if the payment is "extraordinary." As this article was on its way to print, the Ninth Circuit issued a ruling reversing itself and affirming the district court's decision, the implications of which shall be discussed further in the next issue.

Practical Tips

- To the extent possible, determine termination or severance packages for officers in similarly situated companies;
- Termination or severance payments should be reasonably consistent with prior years' salaries and bonuses;
- Officers with similar experience and levels of responsibility should receive similar termination or severance packages; and
- Officers should make such severance terms part of their employment agreement. SEC will have to litigate whether such terms of employment are extraordinary. ◎

---

[2] 261 F. Supp. 2d 1298 (N.D. Ala. 2003).

[3] No. 03-56129 (9th Cir.).

Can the SEC Require Disgorgement of Base Salary?

by Thomas Sjoblom and Jennifer Arnold

In an environment where SEC enforcement actions have become more common and are resulting in increasingly larger penalties, has the SEC exceeded its authority by demanding return of an officer's base salary as a part of disgorgement?

No longer content with disgorgement of just bonuses and incentive-based compensation, the SEC, in several recent cases, has also sought disgorgement of base salary. For example, in its suit against Tyco International Ltd.'s former Chairman, Dennis Kozlowski, and former CFO, Mark Swartz, the SEC explicitly sought non-incentive-based salary compensation.[1]

To date, the SEC has not faced legal challenge to its decision to seek base salary as a portion of disgorgement; however, once put to the test, it is unlikely that the Commission will be able to successfully defend its position. Requiring the forfeiture of base salary as a disgorgement penalty is inconsistent with the purpose of disgorgement and is not supported by case law or statutory grant of authority.

The purpose of disgorgement does not support the forfeiture of base salary. Disgorgement is a remedial penalty whose purpose is to require a wrongdoer to forfeit all ill-gotten gains. Only those funds that can be attributed to the wrongful activity are required to be relinquished by the wrongdoer. Disgorgement is not intended to reach sums that are lawfully earned or owed for services rendered. Disgorgement theory recognizes that "[e]ven the willful wrongdoer should not be made to give up that which is his own."[2]

Because disgorgement reaches only the fruits of illegal conduct, a "court's power to order disgorgement extends only to the amount . . . by which the defendant profited from his wrongdoing."[3] Moreover, to the extent an individual has received benefits derived from both lawful and unlawful conduct, "disgorgement must distinguish between the legally and illegally derived profits."[4] There must be a causal connection between the wrongdoing and the funds sought to be disgorged. The District Court for the District of Columbia has stated, in dicta, that in order to show a causal link sufficient to require the disgorgement of compensation the SEC would have to at least show that (1) the required disclosure would have resulted in the loss of all or part of the individual's job and when such lose would have occurred, or (2) the extent to which the individual's compensation was related to the wrongful conduct as opposed to the rendering of legitimate services.[5]

Base salary is intended to compensate an employee for numerous tasks and services performed for the benefit of the company. Compensation received for performing lawful tasks cannot be considered ill-gotten gains. For disgorgement to encompass an individual's entire base salary, the individual would have to be found to have provided no lawful service or function to the company. Such a situation is rare, as should be the situation in which the SEC can require disgorgement of base salary.

Finally, there is no statutory basis to support disgorgement of base salary under the securities laws. Section 304 of Sarbanes-Oxley allows the SEC to require CEOs and CFOs to reimburse the issuer any bonus and/or other incentive based pay if misconduct leads to a violation of financial reporting requirements. On its face, Section 304 only authorizes the SEC to seek disgorgement of incentive-based pay; it does not authorize the SEC to seek disgorgement of base salary. Had Congress intended the SEC's reach to extend to base salary, it would have expressly listed base salary in Section 304 among the other forms of compensation for which reimbursement could be required. Allowing the SEC to include base salary in disgorgement penalties would extend the Commission's authority beyond that granted to it by statute and contravene Congressional intent.

/ continued page 10

---

[1] See *Drawbaugh, Kevin, SEC Tries New Tactic in Grab at Tyco Exec Salaries*, Reuters (Sept. 19, 2002).

[2] Dan B. Dobbs, Dobbs Law of Remedies, § 4.5(3), 642 (2d 1993) (containing a discussion of the problems relating to apportionment).

[3] *SEC v. Blatt*, 583 F.2d 1325, 1335 (5th Cir. 1978) (noting that a court could only compel a wrongdoer to disgorge profits wrongfully obtained).

[4] But see *CFTC v. British American Commodity Options Corporation*, 788 F.2d 92, 93 (2nd Cir. 1986) (citations omitted) (finding that the CFTC did not have to distinguish between legal and illegal profits because the fraud involved in the case was "systematic and pervasive").

[5] *SEC v. Wills*, 472 F. Supp. 1250, 1276 (D.D.C. 1978).

Disgorgement of Base Salary

continued from page 9

Forfeiture of base salary as a portion of disgorgement is inconsistent with the purposes of disgorgement and unsupported by case law and statutory authority. While this principle has yet to be tested in a court of law, it is unlikely that the SEC will be able to support its position that it has the authority to require disgorgement of base salary.

Practice Tip

Employment agreements and board resolutions should clearly identify each component of compensation, and separately identify base salary. ◎

Employee Indemnification Agreements — the SEC's Newest Enemy

by Jeffrey I. Wasserman

The SEC has begun to flex its ever-growing muscle by deeming companies involved in SEC investigations as "uncooperative" if they abide by their contractual agreements to indemnify corporate officers against civil penalties and disgorgement orders. The likely result for such "uncooperative" behavior is the imposition of monetary penalties in amounts much larger than otherwise would have been possible.

Monetary Penalties

The Director of the SEC's Division of Enforcement has stated:

> We're clearly in the midst of an evolution, if not a revolution, in thinking. In only a decade, we've gone from a regime in which monetary penalties were imposed only rarely to one in which large penalties seem to be part of virtually all significant settlements.[1]

As would be expected, the SEC makes its penalty determinations based on a litany of factors.[2] The SEC considers certain "core factors, which are always relevant[,]"[3] such as the type/egregiousness of the violation, the resulting harm, and the extent of the cooperation provided by the company.[4]

Cooperation

While these core considerations are of course informed by other factors, the SEC places broad emphasis on the level of cooperation a company gives during an investigation.

> If, for example, an entity — whether public company, accounting firm, or regulated entity — or its counsel is recalcitrant during an investigation, misleads the staff, or fails unreasonably to comply with Commission processes, the staff is very likely to seek a penalty in settlement. The penalty is likely to be particularly substantial if the violator's underlying conduct has also resulted in significant investor harm. As you would expect, the provision of extraordinary cooperation, on the other hand, including self reporting a violation, being forthcoming during the investigation, and implementing appropriate remedial measures (including, in the case of an entity, appropriate disciplinary action against culpable individuals), can contribute significantly to a conclusion by the staff

---

1 *Speech by SEC Staff: 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute*, Stephen M. Cutler, Director, Division of Enforcement U.S. Securities and Exchange Commission (Chicago, Illinois, April 29, 2004).

2 See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Rel. No. 44969, Oct. 23, 2001.

3 See n.1, *supra*.

4 *Id*.

> that a penalty recommendation should be more moderate in size or reduced to zero.[5]

Nothing about such a statement would appear exceptional. But it is, because it would appear that now the SEC would label as "recalcitrant" or "uncooperative" those companies that abide by their agreements to indemnify directors, officers and other employees against SEC penalties and disgorgement orders. Thus, there could be serious implications — *i.e.*, large monetary penalties — for those companies that indemnify individuals who are alleged by the SEC to have engaged in wrongdoing.

SEC Opposition to Indemnification Agreements

Corporate indemnification agreements, as well as directors' and officers' insurance coverage, have long been used by corporations to attract and retain talented individuals. This makes good sense, as in today's litigious society, a lawsuit is always just around the corner. But, within 100 days of his appointment, SEC Chairman William H. Donaldson made clear that he opposes such indemnification agreements, at least to the extent that they impact SEC enforcement actions:

> I'm concerned about companies that, under permissive state laws, indemnify their officers and directors against disgorgement and penalties ordered in law enforcement actions, including those brought by the Commission. In my mind, this just isn't good public policy. This is an area in which we may need to consider ways to bring about reform.[6]

This is more than just an esoteric musing by the new Chairman. It has since become policy. "[T]o enhance deterrence and accountability, the Commission recently has adopted a policy requiring settling parties to forgo any rights they may have to indemnification, reimbursement by insurers, or favorable tax treatment of penalties."[7] The SEC advanced this policy largely in response to Xerox's decision to indemnify certain individuals who previously agreed to a settlement with the SEC to pay over $22 million in penalties, disgorgement and interest.[8]

Those companies that choose to indemnify employees (who may be affected by an SEC investigation) may themselves be penalized, which is exactly what happened to Lucent Technologies, Inc. ("Lucent"). As part of a settlement with the SEC, Lucent agreed to pay a $25 million penalty for its lack of cooperation, which included, among other things, failing to provide complete and accurate disclosures regarding its indemnification of certain employees.[9]

According to the SEC, if employees are deemed to be wrongdoers, and their legal fees and penalties are covered by the company (*i.e.*, paid for by the shareholders who are the ones likely to have been wronged in the first place), then the employee is not actually punished and there is little deterrent effect. Thus, the SEC contends that it is not unreasonable for the SEC to demand that individuals forego indemnification as a condition for settling claims made by the SEC. It also is not unreasonable for the SEC to expect complete disclosure from companies regarding their intention to abide by their indemnification obligations.

On the other hand, it is not good policy for the SEC to encourage companies to breach their indemnification agreements. While in this post-Enron world, penalizing alleged wrongdoers is the paramount consideration — whether for its punishment, deterrent or public relations effect — and the SEC would seemingly rather see individuals punished than have companies abide by their contractual indemnification obligations, companies should not be encouraged to deny indemnification *before* final judgment simply because the SEC may later deem the provision of such indemnification "uncooperative" behavior. Until there is a final determination on the merits regarding an SEC investigation, corporate officers have every right to expect indemnification from their companies. The SEC should respect that fact. Unfortunately, the SEC has created an environment in which companies can not be sure that it will.

Practical Tips

This is not to say that indemnification agreements are, or will be, obsolete. But, companies must recognize that, at least as pertains to SEC investigations and settlements, there can be negative ramifications for a company that indemnifies individuals against civil penalties or disgorgement orders.

It no doubt is advisable for companies that seek leniency from the SEC to cooperate fully with any SEC investigation. Thus, as demonstrated by the Lucent case, / *continued page 12*

---

5 *Id*.

6 *Speech by SEC Chairman: Remarks Before the New York Financial Writers Association*, Chairman William H. Donaldson, *U.S. Securities and Exchange Commission* (New York, New York June 5, 2003).

7 *See* n.1, *supra*.

8 *Six Former Senior Executives of Xerox Settle SEC Enforcement Action Charging Them With Fraud*, SEC Release 2003-70.

9 *Lucent Settles SEC Enforcement Action Charging the Company with $1.1 Billion Accounting Fraud*, SEC Release 2004-67.

Employee Indemnification Agreements

continued from page 11

companies would be well advised to fully disclose to the SEC their current indemnification obligations and their plans for abiding by them. At the very least, companies should discuss the issue with the SEC during any investigation. That way, companies can make informed decisions regarding the cost/benefit of adhering to their indemnification obligations and cannot be accused by the SEC of being uncooperative for concealing their intent with regard to indemnification agreements.

Moreover, companies should consider whether it would be worthwhile to draft future indemnification agreements and indemnification policies to exclude, to the extent possible, civil penalties and disgorgement orders rendered under the federal securities laws. That way, the SEC's public policy concerns will be alleviated, and companies and their executives would not run the risk of breaching their indemnification agreements or of having the SEC seek unnecessarily high civil penalties on the ground that it did not receive sufficient cooperation.

Finally, while there is a distinction between advancement of legal fees and indemnification, and while it probably would not be unreasonable or inappropriate for companies to comply with an officer's or director's (even one on administrative leave) demand for the advancement of legal fees during the pendency of an investigation, as a matter of prudence, it again might be advisable first to raise the issue with the SEC.

The key to receiving leniency from the SEC is cooperation with an investigation. One major component of such cooperation is communicating with the SEC — particularly about issues, like those discussed above, that the SEC has red-flagged as troublesome. Companies that are open with the SEC are not likely to be deemed by the SEC to be uncooperative and, thus, will likely avoid receiving larger penalties than otherwise possible. ◎

A Notion of "Collective Scienter"

by Tamara L. Stevenson

Scienter, or fraudulent intent, is a crucial element in any securities fraud claim under Rule 10b-5. To establish scienter, the plaintiff must prove that the defendant acted with intent to deceive or recklessness as to the truth when he or she made the alleged false or misleading statement.

This element is the most likely basis on which defendants can obtain a dismissal and is plaintiff's most arduous hurdle in pleading a securities fraud cause of action. Thus, the defendant's state of mind is a pivotal inquiry in every securities fraud claim. Under Section 21D(b)(2) of the 1934 Exchange Act, which was added by Private Securities Litigation Reform Act of 1995, plaintiffs in a private damage action must plead facts giving rise to a strong inference that the defendant acted with the required state of mind, *i.e.*, scienter. To meet this pleading standard, plaintiffs must allege either facts that constitute circumstantial evidence of both motive and opportunity to commit fraud, or facts that constitute strong circumstantial evidence of intentional behavior or recklessness. See *In re Silicon Graphics, Inc. Secs. Litig.,* 183 F.3d 970, 974 (9th Cir. 1999); *Press v. Chem. Inv. Servs. Corp.,* 166 F.3d 529, 538 (2d Cir. 1999).

This presents an interesting problem, however, when the defendant is a corporation. Does a corporation have a state of mind, and assuming that it does, how is it gauged?

Courts have traditionally solved the problem of determining the state of mind of a corporation by looking to and imputing the state of mind of the individual defendants, *i.e.*, the officers and directors of the corporation, on the rationale that since the corporation can only act through its officers and directors, one or more of those individuals must have the requisite scienter in order for the corporation to be held liable for fraud. Under this traditional perspective, if none of the officers or directors is liable for fraud, neither is the corporation.

Recently, however, this traditional formulation of the corporate state of mind has begun to give way to a collective scienter theory. Under this theory, the corporation's state of mind is gauged by looking at the knowledge of *all* of the corporate employees combined, not just at the individual officers and directors involved in the alleged fraud. This leads to the result that scienter can be adequately pled as to the *corporate* defendant, even though it cannot be adequately pled as to any of the officer or director defendants individually. This is exactly what

has happened in a few recent cases, *i.e.*, claims against the corporate defendant have gone forward, on the basis of adequate allegations of scienter, even though they were dismissed as to the individual defendants on the basis of failure to adequately plead scienter. This somewhat odd result is possible because under the collective scienter theory, one employee's knowledge may be combined with another employee's action and the "collective result" can be attributed to the corporation. The bottom line is that the theory allows certain cases to go forward against the corporate defendant where they would not have under the traditional formulation of the corporate state of mind.

In *City of Monroe Employees Ret. Sys. v. Bridgestone Corp.* 387 F.3d 468 (6th Cir. 2004), *reversed in part on other grounds*, *City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, No. 03-5505, 2005 WL 264130 (6th Cir. Feb. 4, 2005), the Sixth Circuit reversed a dismissal against Bridgestone and its affiliate Firestone, but affirmed the dismissal as to a former officer of the companies. The court found that because the complaint pled only titles and dates of employment as to the former officer, scienter was not adequately pled as to him. As for the company, however, the court found plaintiffs had adequately plead scienter based primarily on internal company documents. Similarly, in *NUI Secs. Litig.*, 314 F. Supp. 2d 388 (D.N.J. 2004), the court found that scienter had been adequately pled as to the corporation, even though it had not been adequately pled as to the individual defendants. The linchpin for the finding that corporate scienter had been adequately pled in *NUI* was that the associate general counsel, who was not a defendant in the case and who did not make any misrepresentations, allegedly knew of the corporation's fraudulent conduct. Likewise, in *In re Motorola Secs. Litig.*, No. 03 C 287, 2004 WL 2032769 (N.D. Ill. Sept. 9, 2004), the court dismissed claims against Motorola officers based on an inadequacy to plead scienter as to them, but nevertheless held that the plaintiffs had alleged a strong inference that Motorola itself, "through its various officials, sought to mislead the investing public" about its vendor financing to a Turkish company.

Finally, the Southern District of New York recently jumped on the collective scienter bandwagon by indirectly, albeit somewhat more brazenly, approving the theory. The court denied summary judgment on the securities fraud claim on the basis that a genuine issue of material fact existed on the issue of scienter. The court declared that "to carry their burden of showing that a corporate defendant acted with scienter, plaintiffs in securities fraud cases need not prove that any one individual employee of a corporate defendant also acted with scienter; proof of a corporation's collective knowledge and intent is sufficient." *In re Worldcom, Inc. Secs. Litig.*, 02 Civ. 3288 (DLC), 2005 WL 89395, at *21 (S.D.N.Y. Jan. 18, 2005).

In addition, the collective scienter theory may impact control person liability under Section 20(a) of the Securities Exchange Act of 1934. In both *NUI* and *Motorola*, the district courts dismissed the fraud claims against the individual defendants, while allowing the corresponding Section 20(a) claims for control person liability to go forward, providing a way for plaintiffs to bring claims against both the company and its officers. By reaching individual defendants through this application of Section 20(a), corporate officers may have to confront the irony of being held liable — for "controlling" (having true power to influence) the corporation — even though they escaped liability on the underlying fraud.

Although the fate of the collective scienter theory is yet to be determined, these cases suggest that it is gaining a foothold in securities litigation. Thus, in any motion to dismiss, corporate defendants may need to argue against the application of the theory to avoid running the risk of facing the fate of the corporate defendants in *Bridgestone*, *NUI*, *Motorola*, and now, *Worldcom*. At the same time, while scienter will continue to be a likely basis for defendants to obtain a dismissal in securities fraud cases, the collective scienter theory may present a dual-thorn in the side of corporate defendants. It presents an opportunity for a plaintiff to allege scienter against the corporation, despite its inability to adequately allege that any of the individual defendants acted with scienter, but then to bring control person liability claims against the individual defendants despite their having escaped liability on the underlying fraud charge. ◎

The corporation's state of mind is gauged by looking at the knowledge of *all* of the corporate employees combined, not just at the individual officers and directors involved in the alleged fraud.

SEC Files Amicus Briefs in Private Securities Fraud Actions Challenging Traditional Notions of Reliance and Causation

by Daniel S. Meyers

This past year, the SEC has participated in two *amicus* briefs addressing fraud-on-the-market liability in private securities fraud actions alleging violations of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5. These briefs provide valuable insight into the SEC's views on future private securities fraud litigation. They were also the focus of extensive commentary by the SEC staff at the PLI SEC Speaks conference in Washington, D.C. in March 2005.

In an effort to make it easier to sue analysts for making material misrepresentations, the SEC filed an *amicus* brief with the Court of Appeals for the Second Circuit in *In re Worldcom, Inc. Sec. Litigation.* In the brief, the SEC argued that, because the element of reliance is presumed under the fraud-on-the-market theory, private plaintiffs should not have to plead it when asserting fraud claims against analysts. Before the Second Circuit was able to rule the case was settled.

One month later, in an effort to correct an erroneous decision on appeal to the Supreme Court from the Ninth Circuit, the SEC participated in a second *amicus* brief concerning fraud-on-the-market. The SEC brief was filed with the United States Supreme Court and argued that private plaintiffs cannot satisfy the "loss causation" element of a securities fraud claim by merely demonstrating that the price of the security was inflated at the time it was purchased. The brief questioned whether the plaintiffs must also establish "a causal connection between the alleged fraud and the investment's *subsequent decline in price*." (emphasis added) On June 28, 2004, the Supreme Court agreed to hear the case. Oral argument has not yet taken place.

Reliance

In the first *amicus* brief, filed *In re Worldcom, Inc. Sec. Litig.*, 219 F.R.D. 267 (S.D.N.Y. 2003), the SEC urged the Second Circuit to hold that "the fraud-on-the-market presumption of reliance applies to all material misrepresentation by analysts." Under this theory, the SEC argued, "a plaintiff in a private action under Rule 10b-5 is not required to show direct reliance on [an analyst's] misrepresentation, but is presumed to have relied on the market price of the security, which reflects all publicly available material information."

The SEC based its argument on the United States Supreme Court's decision in *Basic v. Levinson,*[1] where the court addressed a Rule 10b-5 claim against an issuer of securities. There, the court recognized that reliance is an element of a Rule 10b-5 action, but stated that, in the context of allegations against an *issuer*, an investor's reliance may be presumed and need not be separately alleged. The court reasoned that "[b]ecause most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action." More specifically, the court reasoned that "in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements."[2] In *Basic,* the court held that this presumption of reliance may be rebutted if the defendant submits evidence undermining "the elements giving rise to the presumption, or show[ing] that the misrepresentation in fact did not lead to a distortion of price or that an individual plaintiff traded or would have traded despite his knowing the statement was false."[3]

The SEC argued that this reasoning is equally applicable to

---

1 485 U.S. 224 (1988).

2 *Id*. at 241-42 (citation omitted).

3 *Id*. at 248.

4 339 F.3d 933 (9th Cir. 2003).

5 *Id*. 339 F.3d at 937.

6 *Id*. at 938 (emphasis added).

7 Brief for the United States as *Amicus Curiae*, 2004 WL 1205204, at *10 (May 28, 2004).

8 *Id*. at 11.

9 *Dura Pharmaceuticals Inc., v. Broudo*, 124 S.Ct. 2904 (June 28, 2004).

material misrepresentations by analysts, and that courts should therefore extend the scope of the rebuttable *Basic* presumption. Because the case was subsequently settled, the Second Circuit did not have the opportunity to address this novel theory of analyst liability. However, future plaintiffs are likely to assert similar claims.

Accordingly, in future lawsuits against analysts, investment banks can reasonably expect to see more loosely plead claims for damages, and can expect larger dollar amounts of claims based on a theory of damages that presumes reliance.

Loss Causation

In May 2004, the SEC joined an *amicus* brief filed by the Department of Justice, which argued that the United States Supreme Court should review and ultimately reverse the Ninth Circuit's decision in *Dura Pharmaceuticals, Inc. v. Brouda,*[4] which held that a plaintiff does not have to show that a disclosure and *subsequent drop* in the stock's market price actually occurred. Specifically, the *amicus* brief argues that the Ninth Circuit's decision incorrectly applied the causation element of a private securities fraud claim.

In *Dura Pharmaceuticals*, the Ninth Circuit recognized that in a Rule 10b-5 securities fraud claim, a private plaintiff must show both "*transaction causation*, that the violations in question caused the plaintiff to engage in the transaction, *and loss causation*, that the misrepresentations or omissions caused the harm."[5] The court then held that "loss causation is satisfied where the plaintiff shows that the misrepresentation touches upon the reasons for the investment's decline in value . . . . [but that] it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred, because the injury occurs at the time of the transaction."[6]

The *amicus* brief, disagreeing with the Ninth Circuit decision, argued for reversal on two grounds.[7] First, it argued that "[m]easuring the loss in such a case as of the time of purchase . . . would grant a windfall to investors who sold before the reduction or elimination of the artificial inflation. . . ."[8] Second, the brief argued that application of this standard would combine two separate elements into one, and "render[] loss causation effectively indistinguishable from transaction causation . . . . [because] proof that the plaintiff purchased stock in an efficient market after the defendant made a material misrepresentation will, in the Ninth Circuit, establish transaction causation and loss causation simultaneously." The *amicus* brief, therefore, urged the Supreme Court to review the *Dura Pharmaceuticals* decision and conclusively establish the requisite two pronged showing of transaction and loss causation in a private securities fraud claim.

On June 28, 2004, the Supreme Court agreed to hear the case on a writ of *certiorari*.[9] We anticipate that the Supreme Court will reverse and remand, thereby putting an end to this errant Ninth Circuit decision and the potential for plaintiffs to recover damages, even if they sold before a price drop and suffered no loss. ◎

Secondary Actor Liability in Private Securities Actions in the Wake of *Central Bank*

by C. Ian Anderson and Karen A. Bailey

The Supreme Court in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), held that there is no private cause of action for aiding and abetting claims under Section 10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934.

However, the Supreme Court left it to the lower courts to construe the appropriate standard for determining when a secondary actor (e.g., the securities issuer's accountant, investment bank, law firm, or business partner) may be held liable as a primary violator of these fraud provisions. In the 10 years since Central Bank, two different tests have emerged with respect to primary liability for material misstatements: the stricter "bright line" test and the more relaxed "substantial participation" test.

A related debate, following the Supreme Court's holding in *United States v. Zandford*, 535 U.S. 813 (2002), has also focused on the primary liability standard applica- / *continued page 16*

Secondary Actor Liability

continued from page 15

ble to secondary actors based on *conduct* rather than on a misrepresentation or omission. These cases have focused on the prohibitions contained in the fraud provisions regarding the use of a fraudulent "device, scheme, or artifice" or "any fraudulent act, practice, or course of business." *See, e.g., In re Enron Corp. Sec., Derivative, & ERISA Litig.*, 235 F. Supp. 2d 549, 585 (S.D. Tex. 2002) (concluding that *Zandford* "made crystal clear that a misrepresentation need not be involved and that a suit could be based on Rule 10b-5(a) or (c)"). Here, too, the lower courts are divided on whether to apply a more or less restrictive test.

The SEC whose own ability to bring aiding and abetting actions under Rule 10b-5 based on a finding of "substantial assistance" was confirmed by the Sarbanes-Oxley Act, Exchange Act Section 20(e), 15 U.S.C. § 78t(e) has repeatedly weighed in on the ongoing debates. The SEC supports the more expansive, flexible approach to private actions in order to effectuate what the SEC views as the statute's remedial purpose. In one of the most expansive recent decisions on secondary actor liability, Judge Harmon in the *Enron* matter accorded "considerable weight to the SEC's construction of the statute" and effectively adopted the test put forward by the SEC's *amicus* brief in that case. 235 F. Supp. 2d at 588. The SEC has also recently filed an *amicus* brief in connection with the appeal from the district court's decision in *In re Homestore.com, Inc.*, 252 F. Supp. 2d 1018 (2003). The court in the *Homestore.com* decision held, among other things, that secondary actor liability would only attach where the actor has a "special relationship" to the securities issuer akin to an accountant or auditor, in contrast to being merely a business partner or customer. *See http://www.sec.gov/litigation/briefs/homestore_102104.pdf* ("SEC *Amicus*").

The "Bright Line" Test

Taking their cue from *Central Bank's* emphasis on the element of *reliance* under Section 10(b), several circuit courts have concluded that a secondary actor is only liable under this provision if it makes a misstatement that it knows or should know would be communicated to the public, and the misstatement is attributed to the actor at the time of its public dissemination. *See, e.g., Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998). The bright line test requires that the plaintiff actually rely on a misstatement made by the secondary actor itself. Thus, even if the secondary actor drafted the representations made by the company, if they were not attributed to the secondary actor at the time they were communicated to the investing public and relied upon, there is no primary liability under Section 10(b).

The Bright Line Test for "Deceptive Acts": *In re Homestore.com, Inc.*

The California district court in *In re Homestore.com, Inc.*, although in a jurisdiction governed by the more relaxed "substantial participation" test, introduced new limits on the reach of primary liability claims based on alleged fraudulent "acts" under Section 10(b). Plaintiffs claimed that certain business partners and third-party vendors of the company had knowingly conspired with Homestore.com to inflate the company's revenues through various sham transactions. These sham transactions, plaintiffs alleged, combined with improper accounting by its outside auditors, PricewaterhouseCoopers, and written and oral misstatements made to the SEC, analysts, and the general public, perpetrated a fraud on Homestore.com's shareholders and the investing public.

The district court dismissed the claims against all of the secondary actors, except the auditors, on the basis that plaintiffs could not establish primary liability. The court reasoned that *Central Bank* requires that plaintiffs allege facts establishing that *each defendant* committed its own independent primary violation of Section 10(b). With respect to a scheme to defraud, the court concluded that only those "who actually 'employ' the scheme are primary violators, while those who merely participate in or facilitate the scheme are secondary violators." The "primary architects" of the fraudulent scheme were the officers of Homestore.com, who designed and carried out the scheme. The outside business partners and vendors were merely "aiders and abettors" because they did not "employ" the scheme.

The district court in *Homestore.com* also reasoned that the shareholders were injured by their *reliance* on the misstatements made by Homestore.com, not the fraudulent "scheme" itself. Although the false statements to the public regarding revenues were based on the sham transactions, which were carried out with the active participation of the outside business entities, the court held that the investing public had not actually relied on these sham transactions when making their investment decisions. To be primarily liable, the court concluded, the secondary actors would have had to have "substantially contributed" to the statements made to the investing public.

Finally, the district court held that to be a primary violator

the outside actor must have had some type of "special relationship" with the company. The court noted that in every post-*Central Bank* case where primary liability had been found, the secondary actor had been an auditor, accountant, or underwriter. While PricewaterhouseCoopers met this requirement, the business partners and third-party vendors in *Homestore.com* did not. Thus, while the district court in *Homestore.com* did not impose the bright line test's requirement of attribution, it significantly limited primary liability claims by requiring that the secondary actor have a "special relationship" with the issuer and actually "employ" the scheme upon which the investor directly relies.

In its *amicus* brief in connection with the *Homestore.com* appeal to the Ninth Circuit, the SEC expressed concern that the lower court's holdings would undermine the statutory intent of the fraud provisions by allowing wrongdoers to structure their deceptive behavior in such a way as to avoid primary liability while still causing harm to investors. The SEC noted that the district court's holding was inconsistent with the Supreme Court's directive that Section 10(b) be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." SEC *Amicus* at 10, quoting *Zandford*, 535 U.S. at 819.

In particular, the SEC took issue with the district court's conclusion that a "special relationship" was required. Both Section 10(b) and Rule 10b-5, the SEC remarked, make it unlawful for "any person" to employ any manipulative or deceptive device or engage in fraudulent conduct. The appropriate focus is not whether there was a special relationship, but rather whether the secondary actor participated in fraudulent *conduct* in violation of Section 10(b). The SEC also objected to the district court's holdings that a primary violator must be the "primary architect" or "designer" of the scheme and that the investor's reliance in a scheme like the one alleged in *Homestore.com* is limited to the misstatement disseminated to the public.

In response, the SEC urged the following test for determining when a secondary actor's conduct as part of a scheme to defraud constitutes a primary violation: "Any person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator of Section 10(b) and Rule 10b-5(a); any person who provides assistance to other participants in a scheme but does not himself engage in a manipulative or deceptive act can only be an aider and abettor." SEC *Amicus* at 16. The SEC also contended that the reliance element should be satisfied where "a plaintiff relies on a material deception flowing from a defendant's deceptive act, even though the conduct of other participants in the fraudulent scheme may have been a subsequent link in the causal chain leading to the plaintiff's securities transaction."

The "Substantial Participation" Test

The "substantial participation" test as applied to allegations of fraudulent misstatements under 10(b) does not require that they be attributed to the secondary actor; it is enough that the secondary actor "played a significant role" or was "intricately involved" in drafting or creating the misstatement. See, *e.g., In re Software Toolworks Inc.*, 50 F.3d 615, 628 n.3, 629 (9th Cir. 1994). It is thus sufficient that the plaintiff investor relied on the material misstatement made by the corporation with the substantial participation of the secondary actor, without the plaintiff having to be aware of the role actually played by that secondary actor.

In the *Enron* litigation, plaintiffs alleged that various outside investment banks, law firms, and accounting firms engaged in a scheme with the company to misrepresent its financial condition through the use of unlawful special purpose entities and fraudulent transactions with those entities. *In re Enron Corp. Sec., Derivative, & ERISA Litig.*, 235 F. Supp. 2d 549 (S.D. Tex. 2002). Rejecting the bright line test in favor of the SEC's proposed test, Judge Harmon held that the outside actors could be held to be primary violators of the fraud provisions as long as each defendant made a material misstatement (or omission) or committed a manipulative or deceptive act in furtherance of the alleged scheme to defraud. The district court appeared to also quote approvingly the SEC's explanation that "it would not be necessary for a person to be the initiator of a misrepresentation in order to be a primary violator. Provided / *continued page 18*

The SEC expressed concern that the lower court's holdings would allow wrongdoers to structure their deceptive behavior in such a way as to avoid primary liability while still causing harm to investors.

Secondary Actor Liability

continued from page 17

that a plaintiff can plead and prove scienter, a person can be a primary violator if he or she writes misrepresentations for inclusion in a document to be given to investors, even if the idea for those misrepresentations came from someone else."

Although the district court in *Enron* originally dismissed a couple of the outside defendants on the grounds that plaintiffs had not alleged sufficient facts to establish primary violations, the court later found, upon renewed motions to dismiss the amended complaint, that its newly articulated standard for alleging substantial participation had been met. *In re Enron Corp. Sec. Litig. and ERISA Litig.*, 310 F. Supp 2d 819 (S.D. Tex. 2004). For example, Merrill Lynch contended in its defense that "it had no special business relationship with Enron or its shareholders, that Merrill Lynch did not create, structure or direct any purported misstatements, and that any injury suffered by plaintiffs was caused by Enron's alleged misstatements about its financial status." The district court denied Merrill Lynch's motion to dismiss, holding that "this Court has rejected the narrow construction of the statute and of primary violations employed by *Homestore.com*" and noting that, moreover, "a misrepresentation need not have been made because the statute also applies to conduct."

The district court's holding in *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161 (D. Mass. 2003), also stands in direct contrast to the decision in *Homestore.com* on the issue of primary liability for *conduct* and involved similar allegations of sham transactions by business partners which were intended to allow the company to falsely inflate its revenue. The *Lernout & Hauspie* court held that primary liability could be applied to "any person who substantially participates in a manipulative or deceptive scheme by directly or indirectly employing a manipulative or deceptive device (like the creation or financing of a sham entity) intended to mislead investors, even if a material misstatement by another person creates the nexus between the scheme and the securities market."

The Ninth Circuit will now have to determine whether it wishes to affirm the significant limits placed on primary liability actions based on *conduct* which were articulated by the district court in *Homestore.com* or, as urged by the SEC *Amicus* and consistent with the decisions in *Enron*, *Lernout & Hauspie*, and its own precedent regarding primary liability for misstatements, apply a more relaxed "substantial participation" test that does not require a "special relationship" or direct reliance by the investing public. ◎

SEC and Spitzer Investigations into "Non-Traditional" Insurance Products

By Benjamin Ogletree and Reka Koerner

Several insurance and reinsurance companies recently have received subpoenas from New York Attorney General Eliot Spitzer and the SEC seeking information relating to so-called "non-traditional," "finite" or "loss-mitigation" insurance products.

Regulators are scrutinizing whether there have been abuses and incorrect accounting for these products such that income and losses may have been improperly shifted from one financial reporting period to another. Chadbourne & Parke LLP is closely following these investigations through its insurance/reinsurance and securities regulatory enforcement practices.

Non-Traditional Insurance

These non-traditional insurance products, which include both direct insurance and reinsurance products, have been used for decades as a means of combining the benefits of the insurance and financial markets. Under Generally Accepted Accounting Principles ("GAAP"), non-traditional insurance can only be accounted for as insurance if it transfers adequate insurance risk. If an insurance contract transfers sufficient insurance risk, the insured accounts for it by initially reducing its earnings by the amount of premiums paid and then reflecting a receivable once it is

"probable" that there will be an insurance recovery. On the other hand, if insufficient risk is transferred, non-traditional insurance must be accounted for as a loan or deposit.

Regulators have recently sought information from both sellers and purchasers of non-traditional insurance and reinsurance to determine whether contracts transfer adequate insurance risk and, if not, whether they have been improperly accounted for as insurance instead of a deposit or loan. By way of example, the lack of risk transfer is highlighted where an insurance contract is purchased to cover a triggering event that has already taken place *and* the amount of the loss is quantified and known. These contracts may be viewed as disguised loans or "round-trip" cash arrangements (*i.e.,* a mechanism for an insured to deposit money with an insurer in the form of monthly "premiums," which the insurer — for a fee — refunds to the insured as insurance claim payments).

SEC Enforcement Actions

Recent enforcement actions brought by the SEC illustrate how some non-traditional insurance can be used to smooth improperly the financial statement impact of income and losses in ways that violate the federal securities laws. For example, in September 2003, Brightpoint, Inc., a Midwest cellphone distributor, settled a SEC investigation by agreeing to pay $450,000 and to restate its financials during affected periods in which it used an insurance contract to improperly reduce reported losses. According to the SEC's allegations, in December 1998, Brightpoint purchased a non-traditional insurance contract to cover retroactively $11.9 million in unanticipated losses previously sustained by a foreign operating division – losses that Brightpoint did not wish to report on its financial statements for that period. The insurance contract provided for $15 million in retroactive coverage and a theoretically unlimited amount of prospective fidelity coverage. In fact, however, the insurance contract only covered retroactive losses as there was a side agreement that the fidelity coverage would never be used.

In addition, the SEC alleged that the cost structure of the Brightpoint contract was designed to create the appearance that it did transfer insurance risk. The premium for the retroactive and prospective insurance coverage was a lump sum of roughly $15.3 million to be paid by Brightpoint in monthly installments over the three-year term of the contract. However, since there was an agreement that no claims would be made under the prospective coverage, Brightpoint in fact was paying $15 million in premium for $15 million in coverage plus roughly $300,000 in fees. Thus, the monthly payments were not actual insurance "premiums." Instead, they were a "round-trip" mechanism through which Brightpoint deposited money in the form of monthly premiums that later were refunded to Brightpoint as purported insurance claim payments (minus a fee).

In short, the SEC asserted that this transaction was a deposit arrangement through which Brightpoint improperly spread a loss over several years rather than recognizing it all immediately. Since Brighpoint accounted for the contract as insurance, its financial statements filed with the SEC were inaccurate. By virtue of this alleged conduct, the SEC charged Brightpoint with civil fraud violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), and SEC Rule 10b-5. In addition, the SEC charged Brightpoint with violating Section 13(b)(2) of the Exchange Act by failing to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflected the transactions and dispositions of its assets, and by failing to establish and maintain an adequate system of internal accounting controls.

Insurance and Reinsurance Companies are Now Under Investigation

A recent wave of subpoenas issued to insurance and reinsurance companies by the SEC and the New York Attorney General, Eliot Spitzer, indicate that regulators may be expanding their inquiries. For instance, financial giant Berkshire Hathaway, Inc. recently disclosed that it has received subpoenas from state and federal regulators seeking documentation and information regarding the use of non-traditional or loss-mitigation insurance products from its General Reinsurance unit and all of its affiliates. A number of other property and casualty companies also have recently disclosed their receipt of subpoenas from the SEC and state regulators seeking similar information regarding the manner in which they have reported non-traditional insurance transactions in their public filings. Chadbourne & Parke LLP is carefully following these investigations to determine how the insurance and reinsurance industries will be impacted by these probes. ◎

The Supreme Court's Decision in *United States v. Booker* Opens the Door to Fairer Sentences in White Collar Cases

by Chris Man

Sentences for white collar offenders increased substantially when the United States Sentencing Commission lengthened the sentences under the federal Sentencing Guidelines in 2001, and more recent amendments to the Sentencing Guidelines — following the collapse of Enron and WorldCom — drove sentences higher still.

The harsh prison sentences now imposed in white collar cases have long drawn the criticism of those who point out that the Sentencing Commission failed to consider any meaningful empirical data to support harsher sentences and that numerous studies that demonstrate longer sentences do not add to the deterrent effect. Critics also argue that longer sentences are not needed to protect society from a convicted white collar offender. The reality, as a recent report from the Sentencing Commission shows, is that white collar offenders are the least likely of all offenders to repeat their crimes. See *U.S.S.C., Measuring Recidivism: The Criminal History Computation of the Federal Sentencing Guidelines*, at 13 (2004).

The call for rationality in sentencing white collar offenders largely has fallen on deaf ears in the current "get tough on crime" climate, which has only been made worse by recent corporate scandals. However, white collar offenders may have just received a break from the United States Supreme Court in *United States v. Booker*, 125 S. Ct. 738 (2005). In *Booker*, the Supreme Court ruled that the Sentencing Guidelines, which had essentially turned sentencing into a mathematical exercise, were no longer mandatory but only "advisory." Sentencing courts are still required to consider the Guidelines in setting an appropriate sentence; but courts are required to consider a host of other factors listed in 18 U.S.C. § 3553(a) as well. This will allow courts to consider many factors that will favor white collar offenders, factors that judges were prohibited or discouraged from considering under the mandatory Guidelines regime.

Under Section 3553(a)(1), the sentencing court is now required to consider a defendant's history and characteristics such as the defendant's age, history of good acts and philanthropic, charitable and civic activities. Many white collar defendants have strong histories of good works and community activities, but the Sentencing Guidelines had discouraged courts from giving any consideration to these factors at sentencing. Courts now have the discretion to differentiate whether the defendant is a genuinely good person who made an isolated transgression from someone who may be less worthy of being given a second chance. *See, e.g., United States v. Galvez-Barrios*, No. 04-CR-14, 2005 WL 323703, at *1, 5 (E.D. Wis. Feb. 2, 2005) (imposing a lesser sentence based on the defendant's good character and family circumstances).

Section 3553(a)(2) and (3) also require the court to consider the *need for the sentence to effect* a just punishment, to promote deterrence, and to consider the other kinds of sentences available. These factors were largely irrelevant under Sentencing Guidelines that mechanistically imposed punishment. Many white collar offenders receive collateral punishment by the SEC, such as being barred from serving as an officer or director of a publicly traded company, and are ordered to pay civil fines to the SEC. Such orders are relevant to identifying whether the defendant was punished and whether there is adequate deterrence, but the Sentencing Guidelines discouraged courts from considering such factors. Similarly, being allowed to now consider alternatives to incarceration — such as house arrest and/or community service — may also be beneficial to white collar defendants who can prove that they are not a dangerous threat to society and could benefit society more by directing their talents to improve their communities through community service.

Importantly, Section 3553(a)(7) directs courts to consider the need to make *restitution* to victims in imposing a sentence. While this was not a factor that was ordinarily considered under the Guidelines, some courts have suggested since *Booker* was decided that society and the victims of crime may be better off in some cases by having defendants work to earn money to repay their victims, rather than languish in prison. *See, e.g., United States v. Myers*, No. 3:03-CR-147, 2005 WL 165314, at *2

(S.D. Iowa Jan. 26, 2005) ("In many cases, imposing a sentence of no or only a short period of imprisonment will best accomplish this goal [of making restitution] by allowing the defendant to work and pay back the victim. The guidelines do not account for this. In fact, the mandatory guideline regime forbids departures to facilitate restitution.") Many white collar offenders are well-educated and highly successful, and can make a strong case that they could do more for society by being returned to society to earn money and repay their victims.

No one should misinterpret the fact that sentencing courts have this newfound discretion to mean that courts will actually use it in all instances. While there are many judges who opposed the Guidelines and welcome the opportunity to depart from them, there are many other judges who have suggested that they intend to follow the Guidelines in most cases or will use them as a sort of baseline in determining a presumptively reasonable sentence. *Booker* does not mean that white collar offenders will necessarily receive lighter sentences, but it has opened the door for a creative lawyer to identify his or her client's better attributes for the judge and suggest a sentence that better serves the needs of the defendant and society. ◎

Companies Should Maintain Effective Compliance and Ethics Programs After the *Booker* and *Fanfan* Decisions

by Jack Sena and Karen Yen

Introduction

In the past several months, the organizational sentencing landscape has been dramatically altered by both legislative and judicial developments.

First, on November 1, 2004, significant amendments to the federal Organizational Sentencing Guidelines became effective, including significant changes to the criteria an organization must follow to establish an "effective compliance and ethics program" that can mitigate punishment for an organization charged with a criminal offense. These amendments were implemented pursuant to Section 805(a)(5) of the Sarbanes-Oxley Act of 2002, which directed the United States Sentencing Commission to review and amend the Guidelines and related policy statements to ensure that the Guidelines deter and punish organizational criminal misconduct.

Second, in January 2005, the Supreme Court once more transformed the federal sentencing scheme by ruling in *United States v. Booker* and *United States v. Fanfan*, Nos. 04-104 and 04-105, 125 S. Ct. 738 (2005), that the Guidelines be treated as merely advisory. Courts are still required to consider the Guidelines in imposing sentences, but they are now free to consider other factors as well at the time of sentencing. Organizations that have an effective compliance and ethics program will continue to get credit for having such a program when a court considers the sentence that would be required under the Guidelines, and courts may use their newfound discretion to provide corporations with such programs even more favorable treatment than they received when the Guidelines were considered mandatory. Accordingly, organizations cannot ignore the importance (and benefit) from these Guidelines.

Booker and *Fanfan*

The Supreme Court held in *Booker* and *Fanfan* that the mandatory Guidelines violated defendants' Sixth Amendment right to a jury trial by giving judges the power to make factual findings that increased sentences beyond the maximum that a jury's findings alone would support. This holding (the first portion of the two-part decision) grew out of the similar holding reached by the court in *Blakely v. Washington*[1], where the court invalidated the sentencing guidelines system in the State of Washington. The court reaffirmed its earlier decision in *Apprendi v. New Jersey*[2], which held that any fact, other than a prior conviction, that increases a sentence beyond the statutory maximum must be proved to a jury beyond a reasonable doubt.

The second part of *Booker* dealt with the / continued page 22

1 See *Blakely v. Washington*, 124 S. Ct. 2531 (2004)

2 See *Apprendi v. New Jersey*, 530 U.S. 466 (2000)

Effective Compliance and Ethics Programs

continued from page 21

appropriate remedy. Going forward, the court said the Guidelines should be treated as "advisory." The court held that judges must "consult" the Guidelines and "take account of the Guidelines together with other sentencing goals," but offered little guidance on how judges should balance the Guidelines with these "other" sentencing goals. Sentencing decisions will be subject to appellate review for a determination of their "reasonableness."

Benefits of Effective Compliance Programs

Although the Guidelines are now only "advisory," organizations to which the Guidelines are applicable (corporations, partnerships, associations, joint-stock companies, unions, trusts, pension funds, unincorporated organizations, governments and non-profit organizations) will be well served to continue to maintain effective compliance and ethics programs. Further, directors and executives of these organizations should assume responsibility for the management and oversight of these programs. The amended guidelines set a good standard against which these directors and executives should judge their organizations' own programs. Never required by the Guidelines, these compliance and ethics programs can nonetheless potentially reduce the severity of an organization's sentence (including fines and probation) if it is found to have engaged in criminal conduct.

Reducing the Severity of a Sentence

Under the amended Sentencing Guidelines, two of the six factors that weigh in favor of *decreasing* an organization's sentence are:

- the existence of an "effective compliance and ethics program;" and
- self-reporting, cooperation, or acceptance of responsibility.

An "Effective Compliance and Ethics Program"

An organization that has an "effective compliance and ethics program" is one that:

- promotes due diligence to prevent and detect criminal conduct; and
- promotes an organizational culture that encourages ethical conduct and a commitment to compliance with the law.

To satisfy these criteria, the organization must be an organization that, at a minimum:

- establishes standards and procedures to prevent and detect criminal conduct;
- periodically communicates these standards and procedures to all members of the organization and its agents;
- has a board of directors that is knowledgeable about and oversees the program;
- gives compliance and ethics officers with day-to-day operational responsibility for the compliance and ethics programs direct access to directors, and sufficient authority and resources to carry out their responsibilities;
- requires compliance and ethics officers to monitor and report periodically (at least annually) on the effectiveness of the program to officers and directors;
- excludes persons from positions of substantial authority who have engaged in illegal activities or other conduct inconsistent with an effective program;
- establishes and publicizes a system for individuals to anonymously report violations or seek guidance "without fear of retaliation";
- promotes and enforces the program consistently throughout the organization, with appropriate incentives for compliance, as well as disciplinary measures for criminal conduct or failure to prevent or detect criminal conduct;
- takes reasonable steps to respond appropriately to and prevent further similar criminal conduct; and
- conducts ongoing risk assessments of areas where criminal conduct may occur, and modifies its compliance and ethics program to reduce such risk.

An organization's effort in implementing the program is of the utmost importance. Courts and prosecutors are not impressed by programs they see as mere "paper programs" — programs that are well-written but just sit on a shelf. Prosecutors are quick to note that even Enron had an excellent compliance and ethics program on paper. The problem was that Enron's well-written policy was not implemented in practice. Prosecutors believe that many other companies have good compliance programs on paper, but the corporate cultures of those companies do not truly reflect the concern with compliance and ethics stated in their policies. Organizations need to be careful in documenting the commitment of senior management to make sure that an emphasis on compliance and ethics permeates the corporate culture. In particular, prosecutors and courts will want to see that employees understand that they will be punished for wrongdoing, that employees believe they can

report wrongdoing without adverse repercussions, and that the organization acts appropriately when wrongdoing is reported or discovered.

There is no one compliance and ethics program that would be appropriate for all organizations. Nor will any organization's program remain appropriate indefinitely. The risk of different types of criminal conduct may vary between industries, organizations, locations, and over time. Also, once an appropriate program is set up, it should be periodically reviewed and modified to reduce changing risks of criminal conduct. Accordingly, each organization should establish its own program and continually review and modify it to address changing risks.

The Guidelines require that directors be directly and substantively involved in the oversight of their organization's compliance and ethics program. It is not enough for directors to establish a program and delegate its implementation to subordinates.

The Guidelines require that directors be directly and substantively involved in the oversight of their organization's compliance and ethics program. It is not enough for directors to establish a program and delegate its implementation to subordinates. They must understand the program and directly oversee it. To the extent that day-to-day monitoring of the program is delegated to subordinates, these individuals must periodically report to the organization's officers and directors, and have sufficient authority and resources to make the program effective. All directors, executives, and employees must be trained periodically in the relevant legal standards and procedures.

Self-Reporting

The amended Guidelines strongly encourage prompt reporting of illegal conduct and cooperation with law enforcement authorities. A judge may be less willing to mitigate a sentence of an organization: (1) that unreasonably delayed reporting the offense to the appropriate governmental authorities; or (2) whose officers, directors, or similar high level management officials participated in, condoned, or were willfully ignorant of the illegal conduct. For example, at times the government seems to suggest that credit for cooperation requires outside counsel to, upon engagement, report any illegal conduct. This underscores the extent to which the government expects early cooperation.

Conclusion

Although it is too early to tell the precise direction of sentencing in the country, the trend of many judges since *Booker/Fanfan* has been to afford substantial deference to the Sentencing Guidelines, while other judges seem to view their new-found discretion as an invitation to impose less severe sentences than are called for by the Guidelines. There does not appear to be much judicial support for imposing more severe sentences.

What has remained clear is that organizations have strong incentives to maintain strong compliance and ethics programs for all of the above and following reasons:

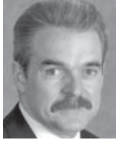
- As part of any sentencing decision, the court is required to do a Guidelines sentencing calculation and at least consider it in making the sentencing decision. Many judges have suggested that they will treat the Guidelines sentence as presumptively correct or as something of a baseline from which they will consider other factors.
- Many judges were previously not supportive of the sentencing guidelines because they felt they were too restrictive. For these judges, they now have more flexibility to exercise greater leniency on those organizations with an effective compliance program.
- In general, judges may be more willing to use their discretion to afford some credit to companies who have acted in good faith to establish an effective compliance program, even if the program in place fails to satisfy all of the elements called for by the Guidelines. ◎

Partners

Kenneth A. Caruso
(212) 408-5581
kcaruso@chadbourne.com

Thomas J. Hall
(212) 408-5487
thall@chadbourne.com

Abbe David Lowell
(202) 974-5678
adlowell@chadbourne.com



Thomas J. McCormack
(212) 408-5182
tmccormack@chadbourne.com

Alan I. Raylesberg
(212) 408-5198
araylesberg@chadbourne.com

Robert A. Schwinger
(212) 408-5364
rschwinger@chadbourne.com

Thomas V. Sjoblom
(202) 974-5636
tsjoblom@chadbourne.com

Counsel

John Moon
(212) 408-1117
jmoon@chadbourne.com

Associates

C. Ian Anderson
(212) 408-2322
ianderson@chadbourne.com

Jennifer E. Arnold
(202) 974-5762
jarnold@chadbourne.com

Scott S. Balber
(212) 408-5466
sbalber@chadbourne.com

Julie A. Campbell
(202) 974-5638
jcampbell@chadbourne.com

JaeYoun John Kim
(212) 408-5446
jkim@chadbourne.com

James I. Lee
(212) 408-5473
jlee@chadbourne.com

Christopher Man
(202) 974-5682
cman@chadbourne.com

Daniel S. Meyers
(212) 408-5340
dmeyers@chadbourne.com

Amy E. Nelson
(202) 974-5789
anelson@chadbourne.com

Benjamin Ogletree
(202) 974-5710
bogletree@chadbourne.com

Tamara L. Stevenson
(212) 408-1052
tstevenson@chadbourne.com

Jeffrey I. Wasserman
(212) 408-5315
jwasserman@chadbourne.com

Karen L. Yen
(212) 408-5314
kyen@chadbourne.com

Securities Litigation and Enforcement NewsWire is an information source only. Readers should not act upon information in this publication without consulting counsel. The material in this publication may be reproduced, in whole or in part, with acknowledgment of its source and copyright. *Securiites Litigation and Enforcement NewsWire* is edited by Thomas V. Sjoblom (tsjoblom@chadbourne.com). For further information, complimentary copies or changes of address, please contact Phillipa Yule, Director of Marketing (pyule@chadbourne.com).

Chadbourne & Parke LLP

30 Rockefeller Plaza
New York, NY 10112
(212) 408-5100

1200 New Hampshire Ave., NW
Washington, DC 20036
(202) 974-5600

350 South Grand Ave.
Suite 3300
Los Angeles, CA 90071
(213) 892-1000

1100 Louisiana, Suite 3500
Houston, TX 77002
(713) 571-5900

Chadbourne & Parke
a multinational partnership
Regis House
45 King William Street
London EC4R 9AN
+44 (20) 7337-8000

Riverside Towers
52/5 Kosmodamianskaya Nab.
Moscow, Russian Federation 115054
+7 (095) 974-2424
Direct line from outside C.I.S.:
(212) 408-1190

Chadbourne & Parke
Radzikowski, Szubielska and Partners LLP
ul. Emilii Plater 53
00-113 Warsaw, Poland
Telephone +48 (22) 520-5000
Facsimile +48 (22) 520-5001

11 Mykhailivska Street, 4th Floor
Kyiv 01001, Ukraine
Telephone +380 (44) 230-2534
Facsimile +380 (44) 230-2535

Beijing Representative Office
Suite 26, Plaza Business Centre
3rd Floor, North Tower
Beijing Kerry Centre
1 Guanghua Rd, Chaoyang District
Beijing 100020, China
+86 (10) 8529-8892

© 2005 Chadbourne & Parke LLP