

# Corporate Fraud Defense Report

May 2006

Volume 1, Number 5

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## Supreme Court Rules SLUSA Preempts "Holders" State Law-Based Securities Class Action

In an 8-0 decision (Justice Alito taking no part), the U.S. Supreme Court reversed a decision by the Second Circuit and ruled that to fall under the ambit of the Securities Litigation Uniform Standards Act (SLUSA), the fraud alleged by class action plaintiffs need merely "coincide" with a securities transaction. The key to SLUSA coverage— and the accompanying preemption of class actions involving securities traded on a national exchange— is deception "in connection with the purchase or sale of any security," not deception of an identifiable purchaser or seller. Thus, SLUSA barred the state-law class action claims of brokers (referred to as mere "holders of securities"), who alleged that Merrill Lynch had disseminated misleading research to its own brokers, who then lost clients when it was revealed that the broker's recommended investments were overvalued.

The Supreme Court looked to the broad purpose of SLUSA "to prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives" of the Private Securities Litigation Reform Act and reasoned that Congress would not have wanted to exempt class-actions brought by holders of securities from SLUSA's bar. The case was a significant victory for Merrill Lynch. However, the Court pointed out that "SLUSA does not actually pre-empt any state cause of action." Rather, "[i]t simply denies plaintiffs the right to use the class action device to vindicate certain claims." *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 126 S.Ct. 1503, 547 U.S. \_\_\_\_\_ (2006).

## Sentencing Commission Proposes Amendment to Eliminate Requirement That Corporations Waive Privilege to Earn Cooperation Credit

On May 1, 2006, the United States Sentencing Commission submitted to Congress amendments to the Sentencing Guidelines that reverse a 2004 guideline change that required corporations and business entities to waive the attorney-client privilege and work product protections to earn credit for cooperating with government officials during investigations. When the Commission adopted the 2004 waiver language, it expected such waivers would "be required on a limited basis," but this appears not to have been the case. According to March 7, 2006 testimony given to the House Judiciary Committee by the U.S. Chamber of Commerce, a detailed survey sponsored by 13 organizations found that the vast majority of inside and outside counsel agreed that a "culture of waiver" has evolved to the point where governmental agencies believe it is reasonable to expect a company under investigation to waive its attorney-client privilege or waiver protections. A majority of outside counsel surveyed whose clients had been investigated reported that the government expected waiver in order to engage in bargaining or to receive more favorable treatment. The amendment will go into effect on November 1, 2006, unless Congress passes

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legislation to rescind or modify it. The 2006 amendments are published on the Commission's website, [www.uscc.gov](http://www.uscc.gov).

## U.S. Chamber of Commerce Wins Mutual Fund Rule Suit

The U.S. Chamber of Commerce recently prevailed in its suit against the SEC challenging the rule requiring mutual fund boards to be independent. The D.C. Circuit Court of Appeals ordered the SEC to reexamine the basis for the rule, which originally required that the chairman of a mutual fund and at least three-quarters of its directors be independent of management. The Chamber challenged the rule, arguing that it had been prejudiced by the SEC's reliance on cost data that was not in the rulemaking record, that the SEC had not allowed enough public comment, and that the SEC had not performed a sufficient cost-benefit analysis of the rule. The court agreed and found that such actions violated the Administrative Procedures Act ("APA") because the data outside the record did not "merely supplement" the rulemaking record without prejudicing the Chamber. In addition, even though the extra-record materials were made available to the public, this did not create an exception to the comment requirements of the APA. The court vacated the rule but gave the SEC 90 days to address the court's concerns, including the public's opportunity to comment upon the costs of the independence requirements. *U.S. Chamber of Commerce v. SEC*, 2006 WL 890669 (D.C. Cir. No. 05-1240, 4/7/06).

## FPA Challenges SEC's Exemption of Brokers From the IAA

The Financial Planning Association ("FPA") is challenging the SEC's recently adopted rule that exempts certain broker/dealers from the requirements of the Investment Advisers

Act, which, among other provisions, creates a fiduciary duty between the investment adviser and the investor. The SEC rule, adopted on April 19, 2005, exempts broker/dealers from the IAA as long as the advice is incidental to the brokerage services and the broker/dealer makes certain disclosures in their marketing materials. The exemption excludes such brokers/dealers from IAA regulation even if the broker/dealer receives "special compensation" in connection with providing investment advice. The SEC created the exemption by redefining the term "investment adviser" as applied in the IAA. The FPA, and other *amici curiae* groups, argued that the SEC went beyond the scope of its statutory delegation of authority by redefining the term "investment advisers" and that the Commission redefined the term in a manner that was inconsistent with the statute. The FPA also challenged the SEC's underlying rationale and rulemaking process. *Amici* briefs were also filed by the Consumer Federation of America, Fund Democracy, Inc., and other groups opposing the SEC decision. *Financial Planning Association v. SEC*, D.C. Cir. Case Nos. 04-1242, 05-1145 (3/23/06) (Brief available at [www.fpanet.org](http://www.fpanet.org)).

## SEC Issues Policy Statement on News Media Subpoenas

On April 12, 2006, the SEC issued a policy statement outlining its guidelines for issuing subpoenas to members of the news media—a move prompted by controversy over recently issued subpoenas. According to the new policy, when a staff member determines that a member of the news media may have information relevant to an investigation, the staff member should (1) determine if the information could be obtained from non-media sources; (2) make all reasonable efforts to obtain the information from those non-media sources; and (3) determine if the

information potentially contained by the news media is essential to the investigation. If the staff determines that the information cannot be obtained from alternative sources, obtaining the information from the media without resort to a subpoena should be attempted.

If negotiations are unable to procure the information, a subpoena should be issued to a member of the news media only if (1) there are reasonable grounds to believe that the sought information is essential to the completion of the investigation; and (2) the staff have exhausted all means of obtaining the information from non-media sources. No subpoenas are to be issued without the authorization of the Director of Enforcement and the General Counsel. If possible, subpoenas should be directed at material information about a limited subject matter, pertain to a reasonably limited period of time, and avoid the need for the media to produce large quantities of unpublished material. The policy statement does not apply to demands for commercial or financial information that is unrelated to the media's news gathering function. SEC Press Rel. 2006-55, 4/12/06.

## Second Circuit Overturns Quattrone Conviction

The Second Circuit Court of Appeals has overturned the 2004 obstruction of justice conviction of former investment banker Frank Quattrone. Quattrone, the former head of Credit Suisse First Boston Corp.'s Tech Group, is accused of obstructing a federal criminal and securities investigation by sending a December 2000 e-mail to employees encouraging them to destroy documents relevant to the investigation. The Second Circuit found that the jury instructions misstated the "nexus" element of the law and required reversal of Quattrone's conviction. The court stated that a conviction for obstruction of justice

requires the jury to find that Quattrone had “specific knowledge of the investigatory proceedings and the subpoenas/document requests” and “must know that his corrupt actions are likely to affect the proceeding.” Because the jury instructions given “eviscerated the nexus requirement,” the Second Circuit reversed Quattrone’s conviction and remanded the matter for retrial. *U.S. v. Quattrone*, 441 F.3d 153 (2nd Cir. 2006).

### Audit Team Sanctioned for Audit Failures and Cover-Up

Three auditors were barred from SEC practice for alleged failures in an audit of Tenet Healthcare, Inc., and subsequent modification of audit workpapers to cover up those failures. An audit team, led by an audit partner, a senior manager, and a manager, conducted an audit of Tenet that resulted in an unqualified August 2002 audit report. In October 2002, an industry analyst speculated that Tenet’s phenomenal growth was attributable to an aggressive charge strategy related to Medicare outlier payments (supplemental payments for treating the extraordinarily sick) which permitted Tenet to recognize substantial increases in revenue. Shortly after release of the report (resulting in an \$11 million loss), the audit team began backdating and modifying its work papers to add outlier payment comments not previously included. Modifications continued even after receipt of an SEC subpoena. Eighteen audit-team members spent over 500 hours modifying inadequate work papers, ostensibly to correct earlier audit failures related, among other things, to inadequate documentation of concerns with disclosure of the aggressive charge strategy. As a result, the audit manager, senior audit manager, and engagement partner have been barred from practice before the SEC. The managers may seek reinstatement, but the partner is barred from practice indefinitely. *In*

*re Madden & Huffman*, SEC Admin. Proc. No. 53574, 3/30/06; *In re Carr*, SEC Admin. Proc. No. 53573, 3/30/06.

### Court Dismisses Citigroup Shareholder Claim for Enron and WorldCom Related Losses

The Delaware Court of Chancery dismissed the claims of a Citibank shareholder alleging that Citigroup directors should have detected and stopped employees’ improper transactions related to Enron and WorldCom. In holding that the plaintiff failed to plead facts sufficient to demonstrate that pre-suit demand was excused, the court emphasized that “Delaware

*Allegations that “some hypothetical, especially zealous board might have discovered and stopped the conduct” were not sufficient to meet Delaware pleading requirements.*

law requires only diligence, not heroism” from its boards. Thus, allegations that “some hypothetical, especially zealous board might have discovered and stopped the conduct” were not sufficient to meet Delaware pleading requirements. In essence, because Citigroup had a wide range of compliance systems in place, in the absence of red flags alerting it to potential misconduct with regard to Enron and WorldCom, the Citigroup board would not be held liable for failing to discover the alleged fraud. *In dicta*, the court warned that in

principle a director could be found liable for remaining ignorant of a large fraud occurring in plain sight—even when the company had a full set of compliance controls in place. However, absent allegations that the fraudulent relationships were central to the corporation’s business, or other well-plead facts to show the directors ignored a mammoth fraud, conclusory claims that the board looked the other way while fraud occurred would be dismissed. *David B. Shaev Profit Sharing Account v. Armstrong*, 2006 WL391931 2/13/06.

### SEC Wins Jury Verdict on Hedge Fund Fraud

A jury in an SEC action has found hedge fund manager Conrad Seghers liable for violating the antifraud provisions of the federal securities laws. The complaint against Seghers and James Dickey, who consented prior to trial to the entry of a permanent injunction and an order to pay disgorgement of \$85,000 plus interest, alleged that Seghers controlled and made investment decisions for Integral Equity, LP, Integral Hedging, LP, and Integral Arbitrage, LP (the “Funds”) and that Dickey marketed the Funds. The Funds raised over \$71 million from approximately 30 investors. The complaint alleged that Seghers and Dickey committed fraud by failing to disclose to investors the substantial losses the Funds incurred and that Seghers had overstated the Funds’ assets by 13% to 84% per month. The SEC also alleged that Seghers and Dickey misrepresented that the Funds had prominent brokerage firms as their prime broker, when, in fact, the Funds never had a prime broker. Dickey has been barred from association with any broker, dealer or investment adviser, with a right to reapply for association after five years. Having concluded the liability phase of the trial against Seghers, the SEC will now seek a permanent injunction, disgorgement, and a civil penalty against him. *SEC*

*v. Seghers*, Case No. 3:04-CV-1320-K (N.D. Tex.); SEC Lit. Rel. No. 196321, 3/30/06.

### SEC Settles Hedge Fund “PIPE” Scheme

The SEC has settled securities fraud and related charges with three New York-based hedge funds (Langley Partners, North Olmsted Partners and Quantico Partners) and their portfolio manager, Jeffrey Thorp, arising from their involvement with 23 unregistered securities offerings called “PIPEs”—Private Investment in Public Equity. The SEC claimed the defendants engaged in a fraudulent scheme to evade the registration requirements of the federal securities laws. Additionally, the SEC alleged that Thorp made materially false representations to the PIPE issuers to induce their initial sale of the securities, and that he engaged in insider trading related to the PIPEs. According to the complaint, the defendants’ scheme involved a series of agreements to invest in PIPEs that were then sold short, usually through “naked” short sales in Canada.

The defendants settled with the SEC, without admitting or denying the allegations in the complaint. They agreed to permanent injunctions from future violations of Section 10(b) of the Exchange Act, Rule 10b-5, and Sections 5 and 17(a) of the Securities Act of 1933. Moreover, the defendants will pay a total of \$15.8 million, comprised of \$8.8 million of disgorged profits plus prejudgment interest and \$7 million in civil penalties. *SEC v. Langley Partners LP*, DDC Case No. 1:06CV00467; SEC Press Rel. No. 2006-49, 3/14/06.

### SEC Hits 5 More Insider Trading Defendants in Plotkin /Pajcin Scheme

Last August, defendants Eugene Plotkin and David Pajcin, a research analyst and a former employee of

Goldman Sachs, respectively, were charged with insider trading based on allegations that they had organized a series of schemes resulting in at least \$6.7 million in illicit gains. On April 11, 2006, the SEC announced charges against 5 additional defendants for their “widespread and brazen international schemes of insider trading.” Plotkin and Pajcin allegedly persuaded a mergers and acquisitions analyst at Merrill Lynch to provide tips regarding upcoming mergers between P&G and Gillette, Novartis and Eon Labs, Duke and Cinergy, Quest and LabOne, and Reebok and Adidas. In another scheme, Plotkin and Pajcin recruited two employees at a printing plant to steal advance copies of *Business Week* so that Plotkin and Pajcin could review information on companies before the information became public. Plotkin, Pajcin, and defendant Monika Vujovic, an exotic dancer, were also planning a scheme wherein exotic dancers would entice bankers to reveal inside information and then pass it on to Plotkin and Pajcin. In total, defendants traded in at least 25 stocks within one year based on the insider information they received from the alleged schemes. *SEC v. Anticevic*, Case No. 05-Civ-6991-KMW (S.D.N.Y., Second Amended Complaint filed 4/11/06); SEC Lit. Rel. No. 19650, 4/11/06.

### Executive Training and Position Can Establish Scier, Court Holds

A federal court has denied a motion to dismiss an SEC enforcement action against several executives and business associates of Metropolitan Mortgage & Securities Co. (“Metropolitan”) for intentionally filing financial statements that improperly recognized gain on four real estate transactions. The court found that the SEC adequately pled scier by alleging that an executive falsely informed Metropolitan’s auditor that a shell company, which had been created to

disguise the true financing of the deal, was an unrelated entity. The auditor had previously informed the executive that recording a gain on a sale wherein 100% of the financing was supplied by Metropolitan and a related company would violate GAAP. Significantly, the court also found a sufficient showing of scier for similar real estate transactions that occurred even before the auditor told the executive that the recognition of a gain, without appropriate related party disclosures, would violate GAAP. Relying on the complaint’s allegations about the executive’s training and position at Metropolitan, the court found that there were sufficient facts to support the allegation that the executive “knew or was reckless in not knowing” that the revenue recognition was improper. The court also rejected the executive’s argument that the complaint’s allegations were deficient because they did not specifically reference GAAP. *SEC v. Sandifur*, 2006 WL 538210 (W.D. Wash., 3/2/06).

### Court Finds Scier Based on Alleged Reckless Ignorance of GAAP Violations

A securities fraud class action against Veeco Instruments, Inc., a manufacturer of components for data storage systems, and several of its high-ranking officers, fraudulently overstated earnings and the profitability of one of the company’s divisions, has survived a motion to dismiss. The defendants claimed that the complaint failed to establish scier. The court pointed out that the complaint specifically identified the statements and speakers, detailed why the statements were fraudulent, and alleged that the defendants had knowledge of or recklessly ignored accounting improprieties which violated GAAP as well as the company’s internal policies. The court found these allegations sufficient to establish scier. The court also found that the PLSRA safe harbor for forward-looking statements did

not protect most of the misstatements alleged in the complaint because the statements did not fall within that category; rather, they were either affirmative representations about current or historical performance or statements that failed to disclose material information about the alleged accounting improprieties. *In re Veeco Instruments, Inc. Sec. Litig.*, 2006 WL 75975 (S.D.N.Y., 3/21/06).

### Affiliates of Issuer Subject to Securities Registration Requirements

The Second Circuit has held that individuals who were affiliates of a corporation involved in a “pump-and-dump” securities fraud scheme were subject to securities registration requirements, even though they terminated their affiliate status before the completion of the fraudulent transactions. The defendants, operators of an investment banking company called U.S. Milestone, agreed to arrange financing for WTS Transnational, Inc., a Massachusetts corporation that was supposedly developing a fingerprint-verification system. The defendants located a shell corporation, Curbstone Acquisition Corporation, which had no assets but which had registered 3.5 million shares with the SEC, and then worked out a reverse stock acquisition whereby Curbstone acquired WTS. The defendants then artificially inflated the share price of the merged entity by issuing false and misleading press releases and distributed hundreds of thousands of shares to friends, relatives, and associates without receiving consideration. The share price eventually plummeted by \$15 million. The defendants, who had resigned from the Curbstone Board of Directors prior to the fraudulent transactions, argued that they were not “affiliates” of Curbstone subject to the securities registration requirements. The court rejected their argument, finding that they were major shareholders whose

ownership and participation was “essential to the fraud,” they were indisputably “affiliates” close in time to the unregistered sales, and there were no equitable arguments in their favor. *SEC v. Cavanagh*, 2006 WL 905911 (2nd Cir. 2006).

### Sophisticated Investors’ Failure to Investigate Bars Recovery

Sophisticated investors in a Ponzi scheme appealed after the jury ruled against them on New York common law fraud claims. The Second Circuit upheld the district court’s rulings and found that “the evidence richly supports a finding that plaintiffs failed to make inquiries commensurate with their sophistication, notwithstanding telltale signs that the investment was a Ponzi scheme or some other implausible kind of bonanza.”

On appeal, plaintiffs argued that the district court erred by (1) instructing the jury that plaintiffs had a duty of investigation triggered by their relative financial sophistication and what they were told about the investment; and (2) refusing to instruct the jury that plaintiffs’ negligence in conducting such an investigation was no bar to their fraud claims. The Second Circuit disagreed, noting that “A plaintiff cannot close his eyes to an obvious fraud, and cannot demonstrate reasonable reliance without making inquiry and investigation if he has the ability, through ordinary intelligence, to ferret out the reliability or truth about an investment.” Thus, the court found ample evidence justifying the district court’s instructions, including: (1) plaintiffs had extensive investment experience with millions of dollars; (2) plaintiffs were told not to make direct contact with the broker or the company in which the investment was to be made or they would be disqualified; (3) plaintiffs were promised a guaranteed return of 72% per year; (4) there was no prospectus or written

material provided; and (5) each of the plaintiffs essentially testified that the deal was “too good to be true.” *Crigger v. Fahnstock and Co.*, 443 F.3d 230 (2nd Cir. 2006).

### No 10(b)-5 Liability For Arms’ Length Vendor Who Did Not Disseminate Fraudulent Statements

According to the Eighth Circuit, liability under Rule 10b-5 does not extend to businesses that enter into arms’ length, non-securities transactions with a party that would then use those transactions to mislead analysts and investors. According to the securities fraud class action complaint, Charter Communications, Inc. allegedly engaged in a scheme to artificially inflate the company’s reported operating revenues and cash flow by, among other things, entering into purportedly sham transactions with two equipment vendors whereby the company agreed to pay the vendors an additional \$20 per set-top box in exchange for the vendors returning the additional payments in the form of advertising fees. Plaintiffs alleged that the vendors knew or should have known that the company intended to account for the transactions improperly and that analysts would rely on the inflated revenues and cash flow. Plaintiffs did not allege that the vendors had any role in disseminating the supposedly fraudulent statements. The Eighth Circuit therefore upheld dismissal of plaintiffs’ claims against the vendors. *In re Charter Communications, Inc.*, 2006 WL 925354 (8<sup>th</sup> Cir. 2006).

### Fourth Circuit Dismisses Securities Class Action in Favor of Bankruptcy Adversary Proceedings

The Fourth Circuit Court of Appeals recently overturned a ruling of the District Court of South Carolina certifying a class action against Finova

Capital Corporation. From 2000 to 2003, The Thaxton Group, Inc. (“TGI”) sold notes to investors under several SEC registration statements. The note holders alleged that these funds were then fraudulently paid to Finova to satisfy a TGI debt. After TGI filed for bankruptcy, note holders filed a class action alleging securities fraud and civil conspiracy claims against Finova. After the district court certified the class of plaintiffs, the Fourth Circuit reversed, finding that a class action was not the superior method to resolve the note holders’ claims, even though the class sought punitive damages and pre- and post-judgment interest, which were unavailable in the bankruptcy proceedings. The court found it would be “inefficient and needlessly duplicative to allow the class action to go forward when the adversary proceeding will likely adjudicate this controversy in the normal course of TGI’s bankruptcy.” *Gregory v. Finova Capital Corp.*, Case No. 05-2118 (4th Cir., 3/14/06).

### Stock Price Higher Than Belatedly Disclosed Offer Undermined Shareholder’s Damages

A portion of a shareholder’s complaint for securities violations that alleged delayed disclosure of a competing bid was permanently dismissed for lack of damages, in part, because the market price of the stock remained above the competing offer price for two months following the approved sale. Pathmark Stores, Inc., disclosed an agreement with Yucaipa Companies, LLC, to invest \$150 million in exchange for 20 million shares of Pathmark stock and a warrant for more shares. An unidentified “Buyer” offered to buy, subject to a due diligence period, all outstanding shares of Pathmark stock at \$8.75 per share. Pathmark’s amended proxy statement included Buyer’s offer and the Board’s rejection of that offer. Buyer then removed the due diligence

requirement from its offer. Pathmark amended its proxy statement twice thereafter, but failed to include Buyer’s new offer. Pathmark made its final amendment to its proxy statement, which included Buyer’s offer and the decision to recommend approval of the Yucaipa offer. The shareholders voted to accept the Yucaipa offer. A shareholder sued, alleging that the delay in disclosure of Buyer’s offer denied him the opportunity to vote for

*The court recognized that a claim for damages was inappropriate where the shareholder was only being “deprived of the opportunity to sell . . . Pathmark stock at a price lower than the market price.”*

Buyer’s offer. The court permanently dismissed the 1934 Exchange Act Section 14(a) claim and Section 20(a) controlling person claim, without leave to amend, because Pathmark’s market-close stock price was \$8.86 on the day of the approval, and remained above \$8.75 for two more months. The court recognized that a claim for damages was inappropriate where the shareholder was only being “deprived of the opportunity to sell . . . Pathmark stock at a price *lower* than the market price.” *Hartman v. Pathmarks Stores, Inc.*, 2006 WL 571852 (D. Del., 3/8/06).

### Department of Labor Reinstates Whistle-Blower and Affirms Damages

The Department of Labor Administrative Review Board has affirmed an administrative law

judge’s ruling ordering a bank to reinstate its former CFO, who was the nation’s first Sarbanes-Oxley whistle-blower. In 2002, Cardinal Bankshares Corporation fired CFO David Welch after he refused to certify the company’s financial statements. After an evidentiary hearing, an ALJ concluded that Cardinal had violated the employee protection section of SOX, ordered Cardinal to reinstate Welch, and awarded Welch back wages, special damages, attorney fees and expenses, and interest. The Administrative Review Board rejected Cardinal’s appeal, affirmed the reinstatement order, and ordered that Cardinal had ten days to move the Board to stay the effect of the order of reinstatement pending a further appeal by Cardinal. *Welch v. Cardinal Bankshares Corp.*, ALJ Case No. 2003-SOX-15; ARB Case No. 06-062, 3/31/06.

### SEC Reaps \$2M Settlement on NCC Late Trading, Market Timing Charges

The SEC has settled civil fraud charges against National Clearing Corporation (NCC), its parent JB Oxford Holdings (JBOH), and three former NCC officers, James G. Lewis, Kraig L. Kibble and James Y. Lin. The SEC had alleged that from June 2002 until September 2003, NCC had (1) facilitated thousands of late trades in mutual funds on behalf of selected institutional customers; and (2) entered into 1% custodial fee arrangements with various institutional customers in exchange for facilitating late trading and market timing in mutual funds.

The settlement provided that (1) NCC would disgorge over \$1 million in illicit gains and pay a \$1 million civil penalty; and (2) that JBOH would cease and desist from future federal securities law violations and refrain from having a controlling interest in or operating a broker-dealer clearing business for five years. Lewis, Kibble

and Lin all agreed to pay civil penalties, were enjoined from Section 10(b) and Rule 10b-5 violations and agreed to be barred from associations with brokers or dealers for varying lengths of time. All defendants settled the charges without admitting or denying the truth of the SEC's allegations. Pursuant to the Sarbanes-Oxley Act, the SEC will attempt to have the disgorgement and civil penalties distributed to the victims of the violations. *SEC v. JB Oxford Holdings, Inc. et al*, SEC Lit. Rel. 19641, 4/5/06.

### Former Tech Execs Face Securities Fraud Charges

Two former executives of a now-defunct technology company, Clarent Corporation, were recently charged with securities fraud over their alleged involvement in a scheme to improperly recognize revenue. Former Clarent CEO Jerry Shaw-Yua Chang was charged with two counts of securities fraud, and former Clarent Asia/Pacific President Matthew Ming-Chang Chiang was charged with two counts of securities fraud, aiding and abetting, and tampering with a witness.

According to the grand jury indictment, Chang and Chiang improperly recognized revenue from several transactions involving various technology companies based in Asia. The defendants' scheme included immediate recognition of revenue from transactions in which customers had been given the right to return the product, the right to cancel the order, or a guarantee that Clarent would find a purchaser for any product that customers could not sell on their own. According to the indictment, the defendants carried out their scheme through undisclosed side agreements establishing contingencies to the sales. None of these contingencies was disclosed to Clarent's independent auditor, Ernst & Young LLP, or its shareholders or the investing public. By not disclosing, the defendants

allegedly caused Clarent's financial statements from Q4 2000 and Q1-Q2 2001 to be materially false and misleading. *U.S. v. Chang*, Case No. 3:06-cr-00187-CRB (N.D.Ca., indictment filed 3/23/06).

### Securities Class Action Survives Particularity Challenges

Shareholders' securities class action claims against J.P. Morgan Chase & Co. has survived a motion to dismiss. Plaintiffs allege that during merger talks between J.P. Morgan and Bank One, Bank One's CEO offered to agree to the deal "for no premium" if he could become CEO of the merged company. J.P. Morgan allegedly rejected the deal because its CEO wanted that position. The complaint asserts that J.P. Morgan paid a 14% premium over market price for Bank One's shares as a result. The proxy statement did not mention the offer from Bank One's CEO, an omission plaintiffs claim violated the §14(a) of the 1934 Act and SEC Rule 14a-9. The defendants filed a motion to dismiss, arguing that the complaint failed to meet the requirements of the PSLRA and Fed. R. Civ. P. 9(b) that fraud be pled with specificity. The court rejected the argument because the complaint alleges that the defendants negligently omitted material information under §14(a), but Rule 9(b) and the PSLRA do not apply to §14(a) claims. The court held that under §14(a), a jury could conclude that the proxy statement's failure to mention the offer from Bank One's CEO, if true, was a material omission, and thus denied the defense motion to dismiss. The court further ruled that the complaint properly alleged that the individual defendants were "controlling persons" under §20(a) of the 1934 Act, but limited the class to shareholders holding stock before the record date for voting. *Blau v. Harrison*, 2006 WL 850959 (N.D. Ill., 3/24/06).

### Caremark Oversight Claim Fails, But Loyalty Claim Survives

Plaintiff in a derivative suit brought claims for breach of the duty of loyalty, breach of the duty of oversight, and common law fraud, alleging that corporate directors and officers had improperly usurped corporate opportunities, engaged in self-dealing transactions, and ran a competing business out of the corporate offices. The court dismissed the oversight claim, but not the breach of loyalty claim. To plead an oversight claim, the complaint must allege facts showing that (1) the directors knew or should have known that violations of law were occurring; (2) the directors took no steps in a good faith effort to prevent or remedy that situation; and (3) such failure proximately caused the losses complained of. *Caremark Int'l Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996). In examining these factors, the court held that the complaint lacked the specificity required to support a *Caremark* or conscious disregard claim because it failed to allege specific facts showing that the accused directors had knowledge or had ignored a "red flag" regarding the alleged wrongdoing, or that the board exhibited a sustained or systematic failure to exercise oversight. Although the interested directors had loyalty obligations, the court found that there was no separate enforceable duty of a director to oversee his own actions or to prevent another director from investing his own money in lines of business similar to those pursued by corporation. *Canadian Commercial Workers Industry Pension Plan v. Alden*, 2006 WL 456786 (Del.Ch., 2/22/06).

## The Corporate Fraud Defense Report™

is a joint effort of the Steptoe & Johnson LLP Securities Litigation and Enforcement, White-Collar and Corporate Responsibility, Investigations and Compliance Practice Groups. For further information, please contact us.

**Reid Weingarten**  
202-429-6238  
rweingarten@steptoe.com

**Mark Hulkower**  
202-429-6221  
mhulkower@steptoe.com

**James B. Moorhead**  
202-429-8067  
jmoorhead@steptoe.com

**Evan T. Barr**  
212-506-3918  
ebarr@steptoe.com

**Frank Burke**  
602-257-5227  
fburke@steptoe.com

**Jeff McFadden**  
202-429-8022  
jmcfadden@steptoe.com

**Matthew J. Herrington**  
202-429-8164  
mherrington@steptoe.com

**John Lovi**  
202-506-3910  
jlovi@steptoe.com

**Stacey Gottlieb, Editor**  
602-257-5277  
sgottlieb@steptoe.com

### Contributing Writers

David Ahlstrom, Philip Bednar, Dennis Blackhurst, Jonathan Drimmer, John Kavanagh, Amy Lester, Nicole Miller,  
Scott Mirelson, Michael Navarre, Mark Newman, Jason Sanders, Jeff Waldstreicher, Kelly Wessels.

To receive this publication by e-mail or to have it sent to a colleague, contact Jane Lundberg at 602-257-7719, [jlundberg@steptoe.com](mailto:jlundberg@steptoe.com).

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