

Corporate Fraud Defense Report

February 2006

Volume I, Number 2

Contents

Improper SEC and USAO Coordination Results in Dismissal of Indictment	2
Hollinger Audit Committee Members Receive Wells Notices	2
SEC Proposes Sweeping Changes to Executive and Director Compensation Disclosures	2
Israeli Bank Hit With \$25 Million in Money Laundering Penalties	3
Oppenheimer Targeted for Alleged Regulatory Failings	3
NYSE Fines Broker for Unsuitable Sales of Variable Annuities	3
Putnam Avoids Fraud Charges by Extraordinary Cooperation With SEC	3
Tax Lawyer's Conviction Overturned	4
Shareholders Fail to Plead Analysts' Reports Were False	4
Section 12(a)(2) Not Applicable When Prospectus is Shown in Private Sale	4
No Specificity Required to Plead Securities Fraud Loss Causation	5
Texas Hedge Funds Pay \$38M to Settle Market Timing Charges	5
Section 806 of SOX is Without Extraterritorial Effect	5
Proposed PCAOB Internal Controls Rule Registers Minimal Controversy	5
SEC Sues Executives for Role in \$2.6 Billion Fraud	6
First Circuit Defines "Efficient" Market That Permits Reliance Presumption in Fraud Class Actions	6
New "Efficient" Market Standard Supports Securities Class Certification	6
Court Refuses to Stay "Discrete" Shareholder Action Pending Internal Probe	6
SEC Charges Hedge Fund Managers With Fraudulent Trading Scheme	7
Verizon Shareholder's Suspicion of Waste Insufficient for Access to Executive Pay Records	7
Revenue Recognition Claims Survive Dismissal In Class Action	7
Guilty Plea for Off-Label Promotion Results in \$36 Million Hit For Eli Lilly	7

SEC Clarifies Standards for Financial Penalties

The SEC Commissioners have issued a unanimous statement discussing guidelines for corporate penalty determinations. The Commission noted its express authority to impose monetary penalties for violation of the securities laws and expressed its intent to provide the "maximum possible degree of clarity, consistency, and predictability in explaining the way that its corporate penalty authority will be exercised." The two primary factors to be considered by the Commission are (1) the presence or absence of a direct benefit to the corporation as a result of the violation; and (2) the degree to which the penalty will recompense or further harm injured shareholders.

Other secondary considerations include (1) the need to deter that particular type of offense; (2) the extent of injury to innocent parties; (3) whether complicity in the violation is widespread throughout the corporation; (4) the level of intent on the part of the perpetrators; (5) the degree of difficulty in detecting the particular type of offense; the presence or lack of remedial steps by the corporation; and (6) the extent of cooperation with the Commission and other law enforcement.

The Commission noted that because monetary penalties may be passed on to shareholders, the SEC is expected to seek, when appropriate, penalties against individual offenders to avoid punishing shareholders who may have been the actual victims of the violation.

As further guidance, the SEC referenced two recently settled actions, *SEC v. McAfee, Inc.* and *In the Matter of Applix, Inc.*, as examples of when monetary penalties will be imposed (McAfee) and when they will not be imposed (Applix). SEC Press Rel. No. 2006-4, 1/04/06.

McAfee Settles SEC Fraud Charges for \$50 Million

McAfee, Inc. ("McAfee") agreed to pay \$50 million to the SEC to settle fraud charges against the security software producer. The settlement was reached the same day the SEC filed suit against McAfee in the Northern District of California. McAfee was accused of inflating revenues by over \$600 million between 1998 and 2000 by paying distributors to hold excess inventory while purchasing additional product. McAfee executives were also accused of fraudulently manipulating reserve accounts and selling tens of thousands of shares of McAfee stock based on inside information before news of McAfee's decreased revenues became public. As part of the settlement, McAfee agreed to retain an independent consultant to examine its internal accounting controls and revenue recognition practices. *SEC v. McAfee, Inc.*, Lit. Rel. No. 19520, 1/4/06.

Applix Executives Charged With Fraud for Improper Revenue Recognition

The SEC has filed a civil fraud action against two former executives and one current director of Applix, Inc. ("Applix"), a Massachusetts software company. The SEC alleges that Applix prematurely recognized revenues

Continued from page 1

and materially overstated its net income on two occasions. Applix then publicized its false revenues as a 74% improvement in net loss and awarded its former CEO and former CFO bonuses for reaching revenue goals. The complaint seeks disgorgement of the bonuses received by the former CEO and CFO and civil monetary damages and injunctive relief against the two former officers and a current Applix director. *SEC v. Goldsworthy*, No. 06-CV-10012-MLW (D.Mass. 1/04/06); SEC Lit. Rel. No. 19521.

In related administrative proceedings, the SEC issued a settled Order Instituting Cease-and-Desist Proceedings against Applix, finding that Applix materially overstated its net income in violation of the securities laws. No financial penalties were assessed against Applix. Applix restated its financial statements for 2001 and 2002 on March 31 and April 4, 2003. *In the Matter of Applix, Inc.*, SEC Admin. Proc. No. 3-12138.

Improper SEC and USAO Coordination Results in Dismissal of Indictment

An Oregon judge dismissed a securities fraud indictment against former executives of FLIR Systems, Inc. due to government conduct “so grossly shocking and so outrageous as to violate the universal sense of justice.” The executives had been indicted based largely on evidence gathered by the SEC, absent disclosure that it was working closely with the U.S. Attorney’s Office and FBI. The court cited documentation showing that the USAO “intentionally shielded its intentions behind the guise of a civil prosecution, resorting to subterfuge to maintain the secrecy of its involvement.” The government “went so far as to instruct court reporters to refrain from mentioning the U.S. Attorney’s involvement and to have [the AUSA on the case] avoid being

near certain interviews for fear his presence would cause the criminal investigation to surface.” The SEC also affirmatively misled one defendant to believe he was not a criminal target and evaded direct questioning from defense counsel about USAO involvement.

The court ruled that suppression of the improperly-gathered evidence would be an insufficient remedy and dismissed the indictment. Anticipating a possible Ninth Circuit reversal, the court also ruled in the alternative that defendants’ statements to the SEC and Wells Submissions were gathered in violation of their due process rights and would, at a minimum, be suppressed. *U.S. v. Stringer*, CR-03-432-HA (D. Or., 1/9/06).

Hollinger Audit Committee Members Receive Wells Notices

The SEC recently served Wells Notices to three of Hollinger International’s audit committee members, alleging that they allowed former Chairman Conrad Black to defraud the newspaper company. The Wells notices center on the audit committee’s role in approving more than \$275 million, including \$218 million in “management fees paid to Black, his former business partners, and Ravelston Corporation, which they controlled. An internal report authored by a special committee of Hollinger’s board concluded that the audit committee showed an “inexplicable and nearly complete lack of initiative, diligence or independent thought.” The report accuses Black of looting the company, and alleges that the audit committee was too trusting of Black and too willing to go along. Black has been indicted on related fraud charges, including charges that he received millions in improper payments, and misappropriated funds to pay for and renovate a New York City apartment, to pay for his use of a corporate jet for a

personal vacation in Bora Bora, and to pay for a lavish surprise birthday party for his wife. *U.S. v. Black*, No. 05-CR-727 (N.D. Ill.).

SEC Proposes Sweeping Changes to Executive and Director Compensation Disclosures

The SEC recently voted to publish for comment proposed rule changes affecting disclosure of executive and director compensation currently reported in proxy statements, annual reports, registration statements, and Form 8-K. The proposal calls for refinement of current disclosure tables and expanded plain English narrative disclosures. The proposals are aimed at: (1) compensation over the last three years, (2) holdings of outstanding equity-related interests received as compensation that are the source of future gains, and (3) retirement plans and other post-employment payments and benefits. Category 1 disclosures include reporting of a single total compensation figure, the value of all stock-based awards, any increases in the accrued value of pension plans, any non-tax qualified deferred compensation earned, and perks totaling more than \$10,000. Category 2 disclosures include amounts of future equity awards and amounts realized on options exercised and stocks vested. Category 3 disclosures include any annual retirement plan benefits payable to executives and, notably, payments or benefits to be paid upon termination or other changes in control. The proposal also requires similar tabular and narrative disclosures of director compensation for the prior year. Chairman Cox describes the proposed rules as “significant revisions” to existing rules that are, “simply put, ...out of date.” SEC Press Rel. No. 2006-10, 1/17/06; Opening Statement by SEC Chairman Christopher Cox, 1/17/06.

Israeli Bank Hit With \$25 Million in Money Laundering Penalties

Israel Discount Bank of New York (IDBNY) has agreed to pay state and federal authorities \$25 million in penalties and implement a comprehensive compliance program to settle charges that it moved \$2.2 billion in illicit funds for Brazilian money transmitters. The settlement resulted from an investigation by the NY Banking Department and Manhattan District Attorney's Office, assisted by the FDIC and the U.S. Financial Crimes Enforcement Network.

According to allegations, Brazilian foreign exchange houses called "doleiros" were nesting their money in IDBNY accounts, in violation of Brazilian money transmission laws and U.S. federal and state banking and anti-money laundering provisions. Authorities alleged that IDBNY failed to investigate and report the delerios' suspicious activities. As part of the settlement, IDBNY agreed to implement a detailed compliance program that includes, *inter alia*: implementation of a Bank Secrecy Act plan (including designation of a BSA compliance officer), annual review of high-risk accounts, establishing a compliance committee that includes three outside directors, filing quarterly compliance progress reports, and establishing independent testing procedures designed to identify and report suspicious activity. FDIC-05-232b. *Copy of Settlement and Cooperation Agreement available upon request.*

Oppenheimer Targeted for Alleged Regulatory Failings

Oppenheimer & Co. and its CEO, Albert Lowenthal, were recently charged by the NASD with knowingly filing inaccurate self-assessment data related to the firm's mutual fund breakpoint practices. The charges

stem from allegations that Oppenheimer provided data that included incorrect share classes in response to the NASD's initial breakpoint practices inquiry and then knowingly failed to correct the flaw after the NASD brought it to Oppenheimer's attention.

This charge is only one in a recent string of regulatory setbacks for Oppenheimer and its related entities. Oppenheimer consented to NASD

"This charge is only one in a recent string of regulatory setbacks for Oppenheimer and its related entities."

censure and a \$250,000 fine for late broker disclosures. Oppenheimer also consented to NYSE and FinCEN findings that it engaged in "numerous supervisory and operation deficiencies" ranging from failing to properly implement suspicious activity reporting and anti-money laundering compliance programs, to failing to make reasonable inquiries as to suspicious wire transfers and intra-firm journal transfers, which resulted in censure and a \$2.8 million fine. Oppenheimer further consented to NYSE censure and a \$1.3 million fine for conduct related to alleged regulatory failings arising from its merger with Fahnstock & Co. in 2003.

Oppenheimer neither admitted nor denied any wrongdoing and has issued a

statement attributing the problems to its rapid growth. NASD News Rel., 1/9/06; NYSE Hearing Panel Decision No. 05-181, 12/29/05; Dept. of Treasury FinCEN Civil Assessment No. 2005-4, 12/29/05; NYSE Hearing Panel Decision No. 05-190, 12/29/05.

NYSE Fines Broker for Unsuitable Sales of Variable Annuities

The NYSE recently censured and fined Chicago member firm David A. Noyes & Co., Inc. ("Noyes") for improper supervision and unsuitable sales of variable annuity contracts to customers. Noyes was fined \$175,000 and required to pay \$375,000 to compensate injured customers. Noyes also agreed to retain an outside consultant to review its policies and procedures relating to its sales of variable annuities.

The improper conduct arose out of approximately 125 variable annuity switches executed at a Noyes branch located in Wausau, Wisconsin. Because many annuities include substantial surrender fees, charges and expenses, the majority of the 125 switches were financially disadvantageous to the customers and therefore unsuitable. The NYSE's finding of improper supervision was partially based upon the fact that four registered representatives of the Wausau branch were members of the branch office manager's immediate family. NYSE Press Rel., 12/12/05.

Putnam Avoids Fraud Charges by Extraordinary Cooperation With SEC

On December 30, 2005, the SEC filed a civil fraud action in the District of Massachusetts against six former officers of Putnam Fiduciary Trust Company ("PFTC") for allegedly defrauding a defined contribution plan and a group of Putnam mutual

funds of approximately \$4 million. The alleged misconduct related to PFTC's failure promptly to invest certain assets of a defined contribution plan client, Cardinal Health, Inc., in January 2001. When markets rose sharply on the day PFTC was to invest the assets, the one-day delay caused the contribution plan to miss out on approximately \$4 million in market gains. The six individual defendants, former officers of PFTC, allegedly shifted approximately \$3 million in losses to Putnam mutual funds and assigned approximately \$1 million in losses to the contribution plan without notifying the client.

The SEC did not bring suit against PFTC as a result of its "extraordinary cooperation" with the Commission, including the fact that PFTC self-reported the defendants' actions, conducted an internal investigation and shared its findings with the SEC. *SEC v. Durgarian*, No. 05-12618 (D. Mass., 12/30/05); SEC Lit. Rel. No. 19517, 1/03/06.

Tax Lawyer's Conviction Overturned

A federal criminal conviction of prominent tax lawyer Daniel Carpenter was overturned because of prosecutorial misconduct. Carpenter, a nationally recognized authority in employee welfare benefits, set up a company to serve as a qualified intermediary for like-kind exchanges under IRS Code §1031. Prosecutors alleged that Carpenter obtained funds from §1031 exchangers through fraud, leading them to believe their money would be held safely in escrow accounts, when in fact Carpenter intended to use the funds to invest in the speculative options market.

Carpenter lost \$8.7 million belonging to seven exchangers in his final two months of trading. He was convicted of mail and wire fraud charges, and the court found that sufficient evidence supported the jury's verdict.

But the court granted Carpenter's motion for a new trial. It held that the prosecution's repeated characterizations during closing arguments to Carpenter "gambling" with exchangers' money were inflammatory and would cause the jury to blame Carpenter for his investment losses and not the crime itself, which occurred when Carpenter received the money under false pretenses. *U.S. v.*

"[The court] held that the prosecution's repeated characterizations during closing arguments to Carpenter 'gambling' with exchangers' money were inflammatory ..."

Carpenter, 2005 WL 3475694 (D. Mass., 12/15/05).

Shareholders Fail To Plead Analysts' Reports Were False

In *In re Credit Suisse First Boston Corp.*, the First Circuit held that shareholders failed to plead that analyst reports were subjectively or objectively false in support of their claim that CSFB analysts issued misleading statements regarding Agilent Technologies in an effort to secure future investment banking business from Agilent. Plaintiffs claimed that CSFB had violated § 10(b) of the Exchange Act and Rule 10b-5 by making misrepresentations that artificially inflated the stock price, that plaintiffs acquired the stock at

inflated prices, and that they suffered losses when the price plummeted. Addressing subjective falsity, the court found "that while plaintiffs' allegations regarding the obvious conflicts of interest and general state of corruption within the CSFB's analyst ranks may be enough to turn the stomach of an ethically sensitive observer, they are insufficient, on their own, to support a fraud pleading with respect to the falsity of the eight 'buy' recommendations issued on Agilent stock." The court also rejected plaintiffs' claim that because the ratings turned out to be wrong, they must have been objectively false, finding that "plaintiffs have pleaded no contemporaneous facts that debunk the legitimacy of the 'buy' ratings when made." *In re Credit Suisse First Boston Corp.*, 431 F.3d 36 (1st Cir. 2005).

Section 12(a)(2) Not Applicable When Prospectus Is Shown in Private Sale

Investors who purchased stock in private offerings do not have a cause of action under Section 12(a)(2) of the Securities Act of 1933. In *Yung v. Lee*, the Second Circuit relied on *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995), in holding that the Act "does not apply to private transactions because such transactions are not subject to the prospectus delivery requirements of the Act."

Plaintiffs invested in a publicly traded transportation company through a series of private purchases and relied heavily on a misleading prospectus for a public offering that was made available to them in meetings. The plaintiffs acknowledged the private nature of the transactions and signed a disclaimer stating that the securities were not offered publicly. Each subscription or letter agreement stated that the stock was being sold without registration and would be considered "restricted securities" as defined by the SEC.

The Court held that liability cannot attach under the Act “unless there is an obligation to distribute the prospectus in the first place (or unless there is an exception).” The Court then found that because the defendants were not obligated to distribute any prospectus to the plaintiffs in connection with the private transactions, the sales could not be deemed to have occurred “by means of a prospectus.” *Yung v. Lee*, 2005 WL 3387699 (2nd Cir. 12/13/05).

No Specificity Required to Plead Securities Fraud Loss Causation

In a decision denying defendant’s motion for judgment on the pleadings, the U.S. District Court for the Eastern District of Michigan concluded that the Supreme Court’s decision in *Dura Pharmaceuticals, Inc. v. Broudo* does not require a securities fraud complaint to include a heightened level of specificity as to the causal connection between misrepresentations and loss. The Court interpreted the *Dura* decision as requiring merely that the plaintiff plead that there was a causal connection between the loss suffered and the defendant’s misconduct.

In a claim for securities fraud against CMS Energy Corporation, plaintiffs alleged that the company defrauded investors into purchasing CMS securities at inflated prices after the company issued inflated statements of revenue by conducting round-trip trading, a practice with no economic purpose – simultaneous pre-arranged buy-sell trades with the same counter party, at the same price and value, and over the same term, resulting in neither profit or loss to either transacting party. Plaintiffs further alleged that CMS’s disclosures of the fictitious revenue based on round-trip trading caused the stock price to fall and investors to suffer losses. The Court distinguished the facts from *Dura*, where plaintiffs alleged only that a

loss resulted from artificially inflated stock prices, and noted that plaintiffs specifically alleged that the loss suffered was a direct result of CMS’s disclosures of its round-trip trading. The Court concluded that CMS was given sufficient notice of both transaction causation and loss causation. *In re CMS Energy Securities Litigation*, 2005 WL 3320865 (E.D. Mich., 12/7/05).

Texas Hedge Funds Pay \$38M to Settle Market Timing Charges

On December 22, 2005, the SEC, the Commodity Futures Trading Commission, and New York Attorney General Eliot Spitzer announced that Veras Capital Master Fund and VEY Partners Master Fund, along with their investment adviser, Veras Investment Partners LLC, and its managing members, Kevin Larson and James McBride, had agreed to pay nearly \$38 million to settle market timing and late trading allegations. The charges alleged that, from January 2002 through September 2003, the managers “used deceptive techniques” to continue market timing in mutual funds that had previously detected and prohibited the Veras hedge funds’ trading. The managers allegedly did so by creating legal entities with names unrelated to “Veras” to disguise the funds’ identities. According to the SEC, the managers also used multiple accounts to divide trades into smaller dollar amounts that would more likely evade detection by the mutual funds. The Respondents have agreed to pay \$35,554,903 in disgorgement and \$645,585 in prejudgment interest. Larson and McBride will each pay an additional \$750,000 penalty and will be barred from any association with any investment adviser for at least 18 months. *In re Veras Capital Master Fund*, SEC Admin. Proc. File No. 3-12133, 12/22/05.

Section 806 of SOX is Without Extraterritorial Effect

In *Carnero v. Boston Scientific Corp.*, the Second Circuit held that whistleblower protection under Section 806 of Sarbanes Oxley is without extraterritorial effect. Plaintiff, a citizen of Argentina, was employed by two Boston Scientific subsidiaries, one in Argentina and another in Brazil. Plaintiff claimed that he was terminated in retaliation for reporting to Boston Scientific that its Argentinean, Brazilian, and other foreign subsidiaries were engaged in accounting misconduct, including improperly inflating sales figures. The Second Circuit found that while plaintiff’s claim would generally fit within the whistleblower protection provision of Section 806, that section “does not reflect the necessary expression of congressional intent to extend its reach beyond” the United States and therefore affirmed dismissal of the claim. *Carnero v. Boston Scientific Corp.*, 2005 WL 360273 (2nd Cir. 1/5/06).

Proposed PCAOB Internal Controls Rule Registers Minimal Controversy

The public comment period recently expired for the Proposed PCAOB Rule on Accounting Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*. The proposal, first announced by the SEC and PCAOB last summer, establishes requirements and provides a direction for auditors engaged to report on whether a previously reported material weakness in internal control over financial reporting continues to exist as of a specific date. The rule provides a formal framework for a voluntary engagement that would be performed solely at the election of the client, providing registrants and investors a mechanism through which the auditor can express an opinion on the status of a material weakness as

of a particular date before issuance of the subsequent year's internal control report.

The proposed rule is available at <http://www.sec.gov/rules/pcaob/34-52990.pdf>. Copies of the publicly-filed comments are available at <http://www.sec.gov/rules/pcaob/pcaob200501.shtml>.

SEC Sues Executives for Role in \$2.6 Billion Fraud

The SEC recently filed a complaint alleging that the former CEO, COO, CFO, and the director of accounts receivable (the "executives") of National Century Financial Enterprises, Inc. ("NCFE"), participated in a scheme to defraud investors in securities issued by NCFE subsidiaries. The fraud caused investors to lose more than \$2.6 billion, and forced about 275 healthcare providers into bankruptcy. Through its subsidiaries, NCFE purchased medical accounts receivable from healthcare providers and issued notes that securitized those receivables. NCFE collapsed after investors discovered massive cash and collateral shortfalls.

The executives allegedly had depleted cash reserves and collateral by making \$1.2 billion in unsecured loans to distressed or defunct healthcare providers, several of which the executives owned or partly owned. They also concealed their fraud by: repeatedly transferring funds between the subsidiaries' bank accounts to mask reserve shortfalls; recording at least \$1 billion in non-existent or ineligible accounts receivable; creating and distributing misleading offering documents, investor reports, and accounting records; and misrepresenting the subsidiaries' cash and collateral. *SEC v. Poulsen*, No. 2:05CV1142 (S.D. Ohio, Complaint filed 12/21/05).

First Circuit Defines "Efficient" Market That Permits Reliance Presumption in Fraud Class Actions

The First Circuit recently joined

the majority of other federal circuit courts by concluding that a securities market can be found "efficient," so as to permit class plaintiffs to enjoy a rebuttal presumption of reliance in "fraud-on-the-market" theory cases, only when the market rapidly reflects *all* publicly available information in its market price. The court rejected the less stringent efficiency standard that

"The court rejected the less stringent efficiency standard that requires only that the market promptly reflect *most* public information."

requires only that the market promptly reflect *most* public information. U.S. Supreme Court precedent permits a class to benefit from a rebuttable presumption of reliance—eliminating the need for individual proof of reliance that is frequently an obstacle to class certification—where the market is deemed "efficient" at the time of the fraud. This presumption is permitted because investors in an open, developed securities market directly rely on the integrity of the market price and thereby indirectly rely on any misleading statements made in that market. Where the market is not "efficient," so the theory goes, it is not reasonable for investors to rely on the integrity of the market price. This efficiency requirement relates only to the flow of information and not necessarily whether the market accurately reflects a stock's true value. *In re Polymedica Corp. Securities Litigation*, 432 F.3d 1 (1st Cir. 12/13/05).

New "Efficient" Market Standard Supports Securities Class Certification

The First Circuit Court of Appeals built on its concurrent ruling in *In re Polymedica Corporation* (see related summary in this issue) by reiterating that a securities market can be found to be "efficient," so as to permit class plaintiffs to enjoy a rebuttal presumption of reliance in "fraud-on-the-market" theory cases, only when the market rapidly reflects *all* publicly available information in its market price. In *Xcelera*, the lower court applied this same standard to certify a securities fraud class action. The First Circuit reaffirmed in this companion case that this was the appropriate standard and specifically emphasized that the market efficiency necessary for a plaintiffs' class to qualify for the presumption was a measure only of its efficiency as to the flow of information into the market and not necessarily its accuracy in predicting a true value of the security, which the defendants claimed was also required. *In re Xcelera.com Securities Litigation*, 430 F.3d 503 (1st Cir. 12/13/05).

Court Refuses to Stay "Discrete" Shareholder Action Pending Internal Probe

Citing the "light burden" imposed by plaintiff's demand, a Delaware judge denied a request by Computer Associates International, Inc.'s ("CA") special litigation committee ("SLC") to stay a shareholder's books and records inspection action filed under 8 Del. C. §220 pending completion of its internal investigation. CA had established the SLC to investigate charges that company officers and directors had breached their fiduciary duties and wasted corporate assets in connection with the 2003 resolution of a shareholder derivative suit. The court noted a number of factors in denying the stay, including that the books and records

action was “substantially encompassed” by other preexisting derivative lawsuits, and that the documents produced in the books and records action were unlikely to yield new or different claims.

The court dismissed the suggestion that the action would distract the internal investigators with litigation over privilege issues, describing such distraction as “relatively minimal in the context of a large investigation conducted by experienced counsel.” The court conceded that the stay request would have almost certainly been resolved differently if the case had been a derivative action, as opposed to a Section 220 action, which it characterized as a discrete “information-gathering tool” for shareholders. *Kaufman v. Computer Associates*, Del. Ch., C.A. No. 699-N, 12/13/05.

SEC Charges Hedge Fund Managers With Fraudulent Trading Scheme

On December 22, 2005, the SEC announced that it had filed civil fraud charges against two former San Francisco hedge fund managers. The SEC alleges that the fund managers defrauded mutual fund shareholders of over \$49 million by placing illegal “late trades” and by fraudulently engaging in “market timing.” The SEC complaint names Brent Federighi and Michael Hoffman in connection with their conduct in managing the Ilytat hedge fund, and Federighi’s management of the Gae Capital hedge fund. According to the SEC, the defendants “deliberately exploited a loophole in their broker’s mutual fund order entry system to place over 3,000 fraudulent late trades (representing over 80% of their hedge funds’ mutual fund trades) in over 400 different mutual funds, allowing them to obtain better prices for their mutual fund shares than ordinary investors received.” The SEC also alleges that the defendants engaged in short-term trading in mutual funds and, when the mutual funds discovered the improper market timing and barred the

hedge funds from investing, the defendants concealed the funds’ identities in order to continue market timing those funds. The SEC seeks injunctive relief, disgorgement of ill-gotten gains, prejudgment interest, and civil monetary penalties. *SEC v. Federighi*, No. C-05-05305-MMC (N.D. Cal., 12/22/05).

Verizon Shareholder’s Suspicion of Waste Insufficient for Access to Executive Pay Records

A Verizon Communications, Inc., shareholder was recently denied access under Delaware General Corporation Law §220 to company records regarding the allegedly wasteful compensation of three company executives. Frank Seinfeld, the Verizon shareholder, alleged that Ivan G. Seidenberg, Lawrence P. Babbio, Jr., and Charles R. Lee received extraordinary compensation of \$205 million for identical services as co-chief executives, which Seinfeld alleged amounted to corporate mismanagement and waste. Under §220, Seinfeld had to demonstrate that his demand was for a “proper purpose” in order to be given access to the requested records. When questioned at his deposition, the only basis Seinfeld was able to identify in support of his records demand was that he was troubled by the large sums paid to the executives. The Chancery Court concluded Seinfeld’s unsupported suspicions of company waste and mismanagement were insufficient under §220 to entitle him to access Verizon executive compensation records. *Seinfeld v. Verizon Comm. Inc.*, 2005 WL 3272365, No. Civ. A. 1100-N (Del. Ch. 10/5/95).

Revenue Recognition Claims Survive Dismissal In Class Action

A motion to dismiss was denied in *In re SupportSoft, Inc. Securities Litigation*, a securities class action. Plaintiffs allege that SupportSoft, a software

manufacturer, violated §§10(b) and 20(a) of the Exchange Act by masking its downward revenue trend to artificially inflate its stock. SupportSoft tried to increase its present revenue by cannibalizing its future revenue stream, plaintiffs claim, by encouraging customers to switch from installment “ratable” software licenses to lump-sum “perpetual” licenses. Revenue under a ratable license is recognized when the payment is made, while under a perpetual license revenue is immediately recognizable. Plaintiffs also allege that company press releases omitted mentioning the licensing conversions or the slowing business environment, but were generally positive. SupportSoft moved to dismiss the complaint, arguing that it made no false or misleading statements because it had disclosed the perpetual licensing trend to the SEC. The court denied the motion, ruling that plaintiffs’ allegations that SupportSoft’s licensing conversions and press releases were designed to affirmatively conceal its suffering revenues state a viable claim under the securities laws. *In re SupportSoft, Inc. Securities Litigation*, 2005 WL 3113082 (N.D. Cal. 11/21/2005).

Guilty Plea for Off-Label Promotion Results in \$36 Million Hit For Eli Lilly

Eli Lilly and Company (“Lilly”) pled guilty in January to a misdemeanor violation of the Food Drug and Cosmetic Act (“FDCA”) in connection with allegations of illegal off-label promotion of its drug, Evista. The guilty plea, entered in federal court in Indianapolis, followed an investigation by the FDA Office of Criminal Investigations. Lilly received approval from the FDA in 1997 to market Evista for the prevention of osteoporosis in postmenopausal women. The criminal information filed with the plea alleges that Lilly had also sought, but had been denied, permission to promote Evista’s ability to reduce the

Continued Next Page

Continued from page 7

risk of breast cancer. Lilly's sales and marketing teams nonetheless developed and executed various strategies to promote Evista to physicians as effective in reducing the risk of breast cancer and cardiovascular disease -- both "unapproved intended uses."

To settle the charges, Lilly agreed to pay a \$6 million criminal fine and forfeit an additional \$6 million. Lilly also settled civil FDCA charges by entering into a consent decree, agreeing to a permanent injunction, and paying an additional \$24 million in equitable disgorgement. *U.S. v. Eli Lilly and Co.*, No. 1:05-cv-01884-SEB-VSS (S.D. Ind. 12/21/05).

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

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

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

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

Stacey Gottlieb, Editor
602-257-5277

Contributing Writers

David Ahlstrom, Philip Bednar, Dennis Blackhurst, Jonathan Drimmer, Mark Newman, Jason Sanders and Matt Stennes.

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

©Copyright 2006 Steptoe & Johnson LLP. All rights reserved. No distribution or reproduction of this issue or any portion thereof is allowed without written permission of the publisher except by recipient for internal use only within recipient's own organization. The opinions expressed in the publication are for the purpose of fostering productive discussions of legal issues and do not constitute the rendering of legal counseling or other professional services. No attorney-client relationship is created, nor is there any offer to provide legal services, by the publication and distribution of this newsletter. This publication is designed to provide reasonable and authoritative information in regard to the subject matter covered. It is provided with the understanding that the publisher is not engaged in rendering legal, counseling, accounting, or other professional services. If legal advice or other professional assistance is required, the services of a competent professional person in the relevant area should be sought. From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers and Associations.

STEPTOE & JOHNSON LLP

1330 Connecticut Avenue, NW
Washington, DC 20036

Presorted Standard
US Postage
PAID
Phoenix, AZ
4594