

# Corporate Fraud Defense Report

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## Securities Disclosure Rules Overcome Radio Broadcast Free Speech Defense

The constitutionality of Section 17(b) of the 1933 Securities Act, which requires stock promoters to disclose to the public payments made to the promoters by the stock's owners, has been upheld. A syndicated radio host and newsletter publisher convicted of failing to disclose an economic relationship with the company whose stock he was promoting on the radio and in the newsletter claimed that § 17(b) unconstitutionally dictated his speech when it forced him to disclose that relationship. The Tenth Circuit concluded that § 17(b) reasonably regulates commercial speech (speech motivated by the promoter's economic interest in selling a stock, which can be more heavily regulated than core free speech). The court reaffirmed that disinterested financial analysis is still entitled to the greatest First Amendment protection, however. The court also held that § 17(b)'s flexibility in the method of disclosure was not unconstitutionally vague, as the radio host claimed. Paid purveyors of financial information should carefully review § 17(b)'s requirements to understand their disclosure obligations. *US v. Wenger*, 427 F.3d 840 (10<sup>th</sup> Cir. 2005).

## Mandatory Advancement of Legal Fees Enforced

In *Homestore v. Tafeen*, 2005 WL 3091887, the Delaware Supreme Court held that a former corporate officer's "personal greed" and "extravagant lifestyle" were insufficient factors in defending the corporation's refusal to advance legal expenses in the face of the corporation's bylaws providing for "unconditional and mandatory advancement rights." Tafeen, the former officer, sought advancement of legal expenses in connection with investigations by Homestore's Audit Committee, the SEC, and the DOJ, a criminal indictment, and numerous civil actions accusing him of pocketing \$15 million as a result of accounting irregularities that led to restatement of Homestore's financials for several periods. The court stated that although Tafeen's "extravagant personal expenditures and lifestyle" and alleged attempt to shelter assets by buying a home in Florida made him "less than sympathetic," he incurred the expenses "by reason of the fact" that he was vice-president of the division responsible for overstatement of revenues. Nothing in the bylaws limited advancement to officers who "refrain[ed] from estate and tax planning, from buying a home in a state that has any form of homestead protection, or from incurring extravagant living expenses." The court also noted advancement of legal expenses promoted the same "salutary public policy that is served by indemnification: attracting the most capable people into corporate service," ultimately rewarding the corporation and its shareholders.

## SEC Issues First SOX Loan-Ban Order

The SEC has settled with two former shipping executives in the first enforcement action brought under Sarbanes-Oxley's ban on public company loans to their executives. According to the SEC's cease-and-desist order, Peter Goodfellow and Stamatis Molaris, the former CEO and CFO of Stelmar Shipping Ltd. (delisted after private acquisition), had authorized interest-free loans to

Continued from page 1

themselves (equivalent to 51% and 71% of their salaries) from Stelmar. Although the executives admitted they were aware of the SOX prohibition at the time they authorized the loans, they claimed the loans were actually “advances” that were not outlawed by the statute. The SEC disagreed and found that the loans were exactly what Congress sought to prevent in enacting Section 13(k) of the Securities Exchange Act of 1934, which was designed to stop executives of public companies from using company funds for personal purposes. Stelmar learned of the loans during its annual audit and took immediate corrective action through SEC filings and by imposing a \$50,000 fine on Goodfellow and a \$30,000 fine on Molaris, who both consented to the SEC’s cease-and-desist order. *In re Goodfellow*, SEC Admin. Proc. No. 3-12117, 12/1/05.

### DOJ Announces New Policy on Demands for Corporate Privilege Waivers

In response to continuing criticism of the Department of Justice’s requirement in federal prosecutions of business organizations that corporations waive the attorney-client or work product privilege in order to be viewed as cooperative and avoid prosecution, Acting Deputy Attorney General Robert McCallum recently issued a memorandum to all U.S. Attorneys mandating the establishment of a written process for reviewing such waiver requests by prosecutors. The memo acknowledges that some U.S. Attorneys’ offices have already established review programs, but directs that every district must now have a written waiver-request review process. The policy, however, leaves to each individual district the discretion to fashion its own review process. The change is viewed by most outsiders as a positive step, but many believe it still falls short of what

is necessary to protect corporate attorney-client and work product privileges. These privileges, they believe, are threatened by the excessive zeal of prosecutors when they insist that a corporation waive its privileges or risk being viewed as uncooperative, particularly when refusal is used to tip the scales in favor of prosecution. *Copy of McCallum Memorandum (10/21/05) available upon request.*

### Bank Hit With \$80 Million Money Laundering Penalty

ABN Amro Bank NV has been fined \$80 million for money-laundering involving countries suspected of having funded terrorism. In their order instituting proceedings, the regulators alleged the following: the bank falsified payments recorded at its U.S. branches to hide transactions between its Dubai branch and banks in Iran and Libya, ABN lacked adequate risk management, legal, audit, and internal control policies and procedures to ensure compliance with U.S. law, and failed to adhere to policies and procedures that it did have, especially those relating to anti-money laundering, including the procedures to implement the Currency and Foreign Transactions Reporting Act, 31 U.S.C. § 5311 *et seq.* and related Treasury regulations. The bank also failed to adequately review such “special procedures” to determine whether the execution of the procedures was consistent with U.S. laws. As a result, one of the bank’s overseas branches developed and implemented “special procedures” for certain funds transfers, check clearing operations, and letter of credit transactions to circumvent the compliance with regulations issued by the Office of Foreign Assets Control (“OFAC”) under 31 C.F.R. Chapter V.

ABN has not admitted or denied liability, but has consented to an order requiring development of an enhanced compliance program and

to pay fines of \$40 million to the Federal Reserve, \$20 million to New York’s bank regulator, \$15 million to Illinois’ bank regulator, and \$5 million to the Illinois bank examiners’ education fund. The penalty is one of the most severe ever imposed for money laundering violations.

### Treasury Finalizes Rule 312 Money Laundering Regulations

The U.S. Treasury Department’s final rule implementing Section 312 of the USA Patriot Act has been submitted to the Federal Register for publication after January, 1, 2006 and will take effect 90 days later. The new regulations require covered financial institutions to establish due diligence programs to detect and report suspected money laundering activity involving foreign correspondent accounts and private banking provisions. Covered institutions must establish a risk-based due diligence program and, in some circumstances, enhanced policies, procedures, and controls to detect and report suspected money laundering activity.

The correspondent banking regulations apply to institutions holding U.S.-maintained correspondent accounts. Covered U.S. institutions include banks, broker-dealers, futures commission merchants and introducing brokers in commodities, and mutual funds. Covered foreign institutions include foreign banks, foreign branches of U.S. banks, businesses organized under a foreign law that, if located in the U.S., would be considered a U.S. institution, and money transmitters or currency exchangers organized in a foreign country.

The diligence requirements also apply to private banking accounts, which are defined as accounts that (1) are established or maintained for the benefit of one or more non-U.S. persons, (2) require a minimum aggregate deposit

of funds or other assets of \$1,000,000 or more, and (3) are assigned to a bank employee who is a liaison between the financial institution and the non-U.S. person. Enhanced scrutiny is required for any private banking account that is maintained for senior foreign political figures, their immediate family members, or their close associates. If the institution does not require a minimum balance of \$1,000,000, the account does not qualify as a private banking account under this rule, but the account is still subject to the internal controls and risk-based due diligence included in the institution's general anti-money laundering program.

### Analyst Indicted for Insider Trading

David Pajcin, a former analyst with Goldman, Sachs & Co., has been indicted on insider trading charges. According to the indictment, from September 2004 through July 2005, Pajcin employed individuals to obtain nonpublic information contained in *Business Week Magazine's* "Inside Wall Street" column prior to the column's release. A favorable review of a company in the "Inside Wall Street" column commonly results in an increase in that company's stock price on the first trading day after *Business Week* is released. From November 2004 through March 2005, Pajcin bought shares in 10 companies based on favorable information contained in "Inside Wall Street" columns that he had obtained prior to their public release. Pajcin then sold those shares either in after-hours trading on the day the column was published online or the following day when issues of *Business Week* were first available. *U.S. v. Pajcin*, S.D.N.Y. Case No. 05-CRIM-1284.

### California May Not Regulate Mutual Fund's Disclosure Statement

A California Superior Court thwarted the state Attorney General's effort to force a leading mutual fund company, American Funds Distributors, Inc., to modify its disclosures and prospectuses. The court held that the attempted regulation was preempted by the National Securities Markets Improvement Act (NSMIA), which reserves the regulation of national securities offerings for the SEC. The court held that the AG's attempt to have a court or jury determine the materiality or adequacy of disclosures was inconsistent with and would undermine the NSMIA by "plac[ing] Investment Company Act Funds in the untenable position of having to seek review of their offering statements by regulators in all states in which their shares are sold." The AG intends to appeal the ruling, stating that "[i]f this decision were allowed to stand, it would represent an unprecedented negation of a state's right to protect consumers from securities fraud." *California v. American Funds Distributors Inc.*, Cal. Super. Ct., BC330774, 11/22/05; *Capital Research and Management Co. v. Lockyer*, Cal. Super. Ct., BC330770, 11/22/05).

### PCAOB Provides Efficiency Guidance on SOX 404 Audits

The PCAOB has issued guidance recognizing that compliance with Auditing Standard No. 2, which implements Sarbanes-Oxley Sections 103 and 404, led to significant inefficiencies not intended by Standard No. 2. The PCAOB's recommendations to reduce these unintended inefficiencies include: (1) integration of the required controls with audits of financial statements, (2) application of top-down approach to audits (rather

than bottom up), (3) implementation of a risk-sensitive approach to audit controls (with greater risks receiving additional controls), (4) utilization of the same transaction to test each separate control throughout the process, rather than testing separate transactions for each control, and (5) more effective utilization of the work of others. The report also explained that insufficient testing of controls, and compensating controls implemented to counter failed controls, led to additional inefficiencies that could be eliminated through adequate initial testing. PCAOB Rel. No. 2005-023, 11/30/05.

### Government Failed To Show CEO Willfully Intended To Trade on Non-Public Information

The Second Circuit recently held that the government failed to prove the CEO of a publicly traded company willfully traded on non-public information related to a tender offer in *U.S. v. Cassese*, 428 F.3d 92 (2d Cir. 2005). Before the tender offer was announced, the CEO had learned that Compuware would soon announce a merger deal with DPRC, but was not told it would be a tender offer. Using two brokerage accounts, the CEO purchased shares in DPRC, which he sold the day the offer was announced. Later that day, he tried unsuccessfully to cancel the sale, and two months later said he had made a stupid mistake. The CEO recently had received, but had not read, a document warning that such trading might violate securities laws.

The court found that the CEO could have believed he was entitled to trade on the information since it was unrelated to his company, he was not involved in the offer, had no fiduciary relationship to Compuware, and had no reason to believe the transaction would be a tender offer. The court

concluded that when viewed in its totality, “the evidence of willfulness is insufficient to dispel reasonable doubt on the part of a reasonable fact finder.”

### Insurers Subject To New Anti-Money Laundering Regulation

New regulations issued by the Financial Crimes Enforcement Network, U.S. Department of Treasury, require insurance companies offering “covered products” to create internal anti-money laundering (AML) programs and file suspicious activity reports (SARs) with the agency. The regulations are presently in effect and mandate compliance by May 2, 2006. “Covered products” include permanent (non-group) life insurance, annuity contracts, and other insurance products “with features of cash value or investment.” Excluded products include group life and group annuities, term life, property, casualty, health, title, and workers compensation insurance, and reinsurance.

The regulations permit some risk-based flexibility, but the insurer’s anti-money laundering program must have: (1) senior management approval, (2) a designated compliance officer, (3) written policies, procedures, and controls, (4) training for appropriate personnel, and (5) independent program testing. SARs must be filed for covered transactions involving a premium or potential payout of \$5,000 or more where the insurer knows, suspects, or should suspect that the transaction potentially involves money laundering. Civil liability protection is extended to complying insurers. The regulations do not apply directly to agents or brokers, but insurers must include them in their programs. Insurers already subject to SEC anti-money laundering regulations as broker-dealers need only ensure their exist-

ing AML programs comply with the new regulations. 31 CFR Part 103, RIN 1506-AA36, AA70.

### Whistleblower Complaint Leads To \$124 Million Settlement for Medicaid Fraud

In November 2005, King Pharmaceuticals Inc. agreed to pay \$124 million to settle civil fraud charges brought under the False Claims Act. Whistleblower Ed Bogart, a King executive, alleged that King underpaid rebates to Medicaid and overcharged government entities for certain drugs from 1994 through 2002. According to the DOJ, King knowingly failed to accurately report the average manufacturer price (AMP) and best price (BP) for prescription drugs reimbursed through Medicaid and failed to pay the correct corresponding Medicaid rebates. King’s reports were also used to determine the ceiling price for drugs purchased under certain federal and state drug programs. King and the HHS Office of Inspector General have entered into a Corporate Integrity Agreement requiring King to establish systems and policies to ensure accurate reporting in the future. The government and Mr. Bogart have not yet reached an agreement on his share of the settlement. The settlement and Corporate Integrity Agreement can be found at [http://www.usdoj.gov/usao/pae/News/Pr/2005/nov/FederalSettlement20Agreement/\(executed copy\).king.pdf](http://www.usdoj.gov/usao/pae/News/Pr/2005/nov/FederalSettlement20Agreement/(executed%20copy).king.pdf).

### French Privacy Watchdog Offers Compromise for SOX Whistleblowing Compliance

Under the whistleblower provisions of the Sarbanes-Oxley Act (SOX), corporations must establish procedures whereby employees may confidentially and anonymously report concerns regarding questionable accounting or auditing practices.

To satisfy this requirement, many U.S. corporations have established “hotlines” for their employees to file anonymous complaints. Due to workplace privacy concerns, however, European courts have met this requirement with reluctance. For example, the French Libourne High Court recently ordered the European subsidiary of a U.S. corporation to withdraw a whistleblower inquiry based on an anonymous report. (R.G. 05-143, 9/15/05) Furthermore, the French Data Protection Authority (CNIL) worried that complying with the SOX whistleblower provisions ran counter to French historical and social principles, which convey suspicion regarding denunciations from an anonymous accuser.

Responding to these concerns, in November, 2005, the CNIL approved new rules for French corporations seeking compliance with SOX. (8 CGR 120, 10/3/05) The CNIL suggested that whistleblower hotlines be limited to core financial sector activities, *i.e.*, accounting, auditing, banking records, and anti-corruption activities. The CNIL also suggested that corporations take “particular precautions” with anonymous tips by establishing in-house procedures to manage, process, and store information collected from whistleblower hotlines.

### Securities Fraud Claims Survive Based on Failure to Disclose Loss of Major Contract

Securities fraud class action plaintiffs defeated a motion to dismiss in *In re Cambrex*, 2005 WL 2840336 (D.N.J. 10/27/05). Plaintiffs have alleged that Cambrex committed fraud by failing to disclose and account for the loss of its largest manufacturing contract and that Cambrex knew about the loss when it issued forward-looking statements predicting continued revenue

growth. The court refused to dismiss the claim, holding that plaintiffs adequately alleged that Cambrex had actual knowledge that it would be impossible to replace the lost revenue in 2003, making the earnings guidance it had issued impossible to achieve, and that Cambrex had a duty to disclose this information to make the earnings guidance not misleading.

The court also found that plaintiffs adequately pled accounting fraud by alleging that Cambrex knew since 1997 that its write-offs of inter-company expenses did not comply with GAAP—the same kind of undisclosed expenses Cambrex restated in 2003. The court, however, did dismiss claims based on insider trading, finding that there was nothing unusual about the scope of the timing of the trades to support an inference of scienter.

### Plaintiffs Win Right to Loss Causation Discovery

Plaintiffs in *Plumbers & Pipefitters Local 572 Pension Fund v. Cisco Systems, Inc.* (N.D.Ca. C01-20418JW) alleged that high-ranking company officers, directors and accountants issued a series of false and misleading public statements regarding Cisco's accounting, financial results, business and prospects, in violation of §§10(b) and 20(a) of the Exchange Act and Rule 10b-5. Plaintiffs alleged the false and misleading statements artificially inflated Cisco's stock price, and that while the stock price was inflated, the individual defendants dumped over \$609 million of their personal Cisco stock. After the individual defendants sold their stock, Cisco announced its financial results for the fiscal 2001 second quarter, which allegedly caused Cisco's stock to fall 17%. Cisco moved to dismiss based on the U.S. Supreme Court decision in *Dura Pharmaceuticals, Inc. v. Broudo* regarding loss causation in fraud cases. The court allowed

plaintiffs to proceed, holding that the complaint's allegation that there was a steep drop in the price of Cisco's stock after the officers began to disclose the company's financial condition adequately plead loss causation, *i.e.*, that the alleged misrepresentations and the subsequent decline in the stock price were causally connected.

### Shareholders' Claims Against Outside Auditor Dismissed

A federal court has dismissed §10(b) and Rule 10b-5 securities fraud claims against Warnaco's outside auditor, Deloitte & Touche. Shareholders alleged that audited financial statements contained affirmative misrepresentations and omissions, and that the audit firm had a duty to disclose misstatements and material omissions contained in unaudited financials that Deloitte had "examined and reviewed."

The complaint alleged that Deloitte failed to disclose Warnaco's "true financial condition and internal chaos," and, as a result, (1) the class acquired Warnaco stock at artificially inflated prices, (2) Warnaco was unable to obtain waivers from its lenders of its default on its credit agreement, and (3) Warnaco's stock price declined to almost zero and it went into bankruptcy. However, the complaint never alleged that Deloitte made statements contrary to its audit opinion, which disclosed Warnaco's inability to obtain permanent waivers from its creditors, or that Deloitte knew Warnaco's published numbers, which indicated it was not in default, were fabricated. Thus, the court held that plaintiffs failed to allege loss causation.

The court also held that Deloitte had no duty to correct misstatements in financial statements it had not audited, and plaintiffs' allegation was tantamount to a claim for aiding and abetting securities fraud, which could

not survive under well-established precedent. *In re The Warnaco Group Securities Litig. II*, 388 F.Supp.2d 307 (S.D.N.Y. 2005).

### Judge Recommends Dismissal of Fraud Claim for Failure To Plead "Loss Causation"

A federal magistrate judge has recommended dismissal of a fraud claim against Alkermes, a drug manufacturing company. *In re Alkermes*, 2005 WL 2848341 (D.Mass. 10/6/05). Plaintiffs alleged that Alkermes made false statements in its press releases and 10-K filings about the readiness of its manufacturing facility to produce a drug that was awaiting FDA approval, and that these statements induced investors to purchase Alkermes stock. Plaintiffs claimed they were damaged when the FDA subsequently issued a non-approval letter for that drug, causing Alkermes' stock to lose seventy-five percent of its value.

The magistrate, however, found no allegation in the complaint that the manufacturing-related statements had any connection to the FDA non-approval letter and the subsequent decline in Alkermes' stock price. He concluded that in the absence of any allegation that the statements "concealed something from the market that, when disclosed, negatively affected the value of the security," the Plaintiffs have failed to allege an element of their claim, loss causation."

### Failure To Demonstrate "Loss Causation" Leads to Dismissal of Investor Lawsuit

The court awarded summary judgment to Citigroup and one of its investment advisors finding no evidence of "loss causation" for plaintiffs' losses on Smart Serv Online (SSOL) stock. Plaintiffs alleged the advisor fraudulently induced them to

invest in SSOL by falsely representing that SSOL had signed substantial contracts with large corporations, had obtained large sources of financing, and that Citigroup was going to invest substantially in its stock. Plaintiffs claimed that, absent these false statements, they would have sold their SSOL stock long before its value dropped.

The court held that no reasonable jury could find that the alleged misrepresentations caused the plaintiffs' losses because the entire technology industry suffered an economic collapse during the relevant time period; thus, plaintiffs would have lost their investment regardless of the alleged misrepresentations. The court also held that plaintiffs' state law claim alleging negligent supervision by the adviser's firm was preempted by the Securities Litigation Uniform Standard Acts because the complaint alleged the misrepresentations were made in connection with the purchase and sale of securities. *Ray v. CitiGroup Global Markets*, 2005 WL 2659102 (N.D. Ill. 10/18/05).

### Shareholders' Claims Dismissed for Failure To Establish Scienter

Shareholders in *In re Stonepath Group, Inc.* failed to plead specific facts showing scienter to support a claim that the transportation company's corporate officers used a "manipulative or deceptive contrivance" in connection with the purchase or sale of securities. The shareholders' misrepresentation claims failed to name names or describe events with sufficient specificity to show that the corporate officers knew of under-accrual or other accounting and financial reporting problems establishing that the company was not profitable. Rather, the shareholders merely quoted press releases, SEC

filings, and conference calls wherein the corporate officers stated that the company was profitable. The court emphasized that scienter in the context of securities fraud requires showing "an extreme departure from the standards of ordinary care." Claims that are "essentially grounded on corporate mismanagement" or claims

"No reasonable jury could find that the alleged misrepresentations caused the plaintiffs' losses because the entire technology industry suffered an economic collapse during the relevant period."

that demonstrate motives "generally possessed by most corporate directors," such as the desire to access credit or maintain a good stock rating, do not evidence scienter. 2005 WL 2810791 (E.D.Pa. 10/27/05).

### Hedge Fund's Alleged Market-Timing Scheme Leads To \$180 Million Settlement

A recent SEC order details a more than \$180 million total settlement of allegations against a hedge fund operated by Millennium Partners L.P., Millennium Management L.L.C., and

Millennium International Management L.L.C., and its key personnel ("Millennium") for deceptive market timing practices designed to circumvent mutual fund prohibitions on market-timed transactions. The settlement includes provisions relating to management restructuring and increased regulatory oversight of Millennium. The allegedly fraudulent transactions led to tens of millions of dollars in profits for Millennium, which the settlement was designed to recapture. The SEC's complaint against Millennium included allegations that it had: (1) created over 100 new trading entities, (2) employed variable annuity contracts, (3) "cloned" (obtained multiple registered representative numbers for the same individual) or alternated existing representative numbers on trades, (4) broke-up larger transactions into smaller pieces and left small positions in place when trading out of a mutual fund, (5) used clearing brokers that aggregated trades, and (6) employed "sticky" assets with broker-dealers that had previously negotiated trading capacity with the mutual funds, all allegedly in an effort to shield Millennium from mutual fund market timing detection programs. Millennium has admitted no wrongdoing and its cooperation was acknowledged in the order. SEC Admin. Proc. No. 3-12116, 12/1/05; 2005 WL 3240598.

### Ameriprise Pays \$57 Million To Settle Market-Timing, Revenue Sharing Charges

Ameriprise Financial, Inc., formerly American Express Financial Corporation (AEFC), has agreed to pay \$15 million in disgorgement and civil penalties to settle charges that it improperly allowed market timing of American Express Funds (AXP Funds). According to the SEC, AEFC improperly allowed approximately 20 customers to market-time the AXP

Funds and allowed a known market-timer to market-time variable annuity products sold by AEFC. The SEC also found that 27 past and present AEFC employees market-timed various AXP Funds through their 401(k) plans and that AEFC had failed to implement procedures to monitor employees' 401(k) accounts for such activity.

Ameriprise Financial Services Inc., formerly American Express Financial Advisors (AEFA), also agreed to pay \$30 million to the SEC and \$12.3 million to the NASD to settle revenue sharing charges. According to the SEC, AEFA improperly received tens of millions of dollars annually in revenue sharing payments from affiliates of mutual fund families. AEFA improperly required affiliates of mutual fund families to pay average revenue sharing to participate in AEFA promotional programs. Revenue sharing fees were based on range of 10 to 25 basis points, calculated as a percentage of a particular fund family's total assets.

### Federated Pays \$72 Million on Market Timing and Late Trading Charges

Three affiliates of Federated Investors Inc., one of the country's largest mutual fund managers, have agreed to pay \$72 million to settle charges of market timing and late trading violations. The SEC alleged that Federated Investment Management Company (FIMC) entered into market timing agreements with three investors, including Canary Capital Partners LLC, creating a conflict of interest that was never disclosed to other shareholders or the Board of Trustees. Federated Securities Corporation (FSC) and Federated Shareholder Services Company (FSSC) also improperly entered into a joint arrangement with the Federated mutual fund complex which allowed Canary Capital to market time certain mutual funds in

exchange for an investment of "sticky assets" without first obtaining an SEC approval order. FSSC also allowed its employees to improperly process late trades by accepting orders from investors after 4:00 p.m. and processing those orders at that day's current net asset value (NAV) rather than the next day's NAV. In settlements reached with the SEC and State of NY, Federated agreed to pay \$27 million in ill-gotten gains and \$45 million in cash as a civil penalty, in addition to the \$8 million previously paid to the wronged Federated funds. *In re Federated Investment Management Co., et al.*, SEC Admin. Proc. No. 3-12111, Rel. No. 34-52839, 11/28/05.

### Directors Subject To Entire Fairness Review on Former Shareholders' Direct Breach of Fiduciary Duty Claims

In *Gentile v. Rossette*, Del. Ch., C.A. No. 20213-NC, 10/20/05, the Delaware Chancery Court dismissed former shareholders' stock diminution claim on summary judgment, but refused to dismiss their direct breach of loyalty claims against the corporation's two directors in a failed merger that resulted in a \$6 million loss. The shareholders alleged that the deal was structured to allow one of the two directors, Rosette, who was also the majority shareholder, to receive special consideration not available to other former shareholders. In preparation for the merger, Rosette converted stock at 5 cents a share, rather than fifty cents a share as provided in the debt instruments, increasing the percentage of his stock from 61 to 93 percent. Additionally, the directors structured the merger so that Rosette received a put agreement allowing him to require the company to buy back his shares in the post-merger company, a significant benefit not offered to the other shareholders.

Entire fairness review was required even though the second director, Bachelor, was purportedly independent and disinterested. Bachelor had approved the merger without ascertaining whether Rosette was receiving special consideration. The court stated that the former shareholders had every right to expect the independent director to ascertain whether Rosette, as majority shareholder, had negotiated significant favorable terms for his exclusive benefit. Bachelor's "abject failure to take any steps to meet this expectation" precluded summary judgment.

### Controlling Shareholders on Both Sides of Mergers Risk Exacting Entire Fairness Review

The Delaware Chancery Court recently concluded that a controlling shareholder was subject to "entire fairness" review rather than the more deferential business judgment rule where minority shareholders were cashed-out in a merger negotiated by the controlling shareholder who positioned himself (or affiliated entities) to receive \$491 million in compensation, plus a 20.4 percent interest in the post-merger company. Entire fairness review requires that the controlling shareholder "demonstrate his or her utmost good faith and most scrupulous inherent fairness of the bargain," a very exacting standard. The harsher standard was potentially applicable because the allegations against the controlling shareholder could support a reasonable inference that he was sufficiently conflicted at the time he negotiated the sale since he agreed to a lower sale price in order to secure a greater profit from his investment in the new company. The court determined entire fairness review applied, even where a special committee and a majority of independent and disin-

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interested board members had approved the transaction. *In re LNR Property Corp. Shareholders Litig.*, Del. Ch., C.A. No. 674-N, 11/4/05.

## The Corporate Fraud Defense Report™

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