

# Corporate Fraud Defense Report

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## Homestore Dismissal Upheld – Allegations Failed to Show Defendants Were “Primary Violators” Under § 10b

The Ninth Circuit upheld the dismissal of class-action securities fraud claims against AOL Time Warner Inc., Cendant Corporation and other business-partner defendants who allegedly engaged in sham transactions with Homestore.com. Although plaintiffs claimed the defendants, along with Homestore, its officers, and auditor PriceWaterhouseCoopers, committed securities fraud by engaging in round-trip transactions allowing Homestore to recognize its own cash as revenue, the court found that plaintiffs had not adequately alleged that the defendants were “primary violators” of §10(b). Citing *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), the court reasoned that “participation in a fraudulent transaction by itself” did not qualify the participant as a primary violator of § 10(b), when the deceptive nature of the transaction was not an intended result of the defendant’s own conduct. Rather, each defendant must commit an act that is deceptive when viewed alone.

In explaining this holding, the court pointed out that participation in a legitimate transaction—without a deceptive purpose or effect—would not be a primary violation even if the defendant knew or intended that another party would manipulate the transaction to effectuate a fraud. To establish a primary violation of §10b, the conduct of each defendant “must be viewed alone for whether it had the purpose and effect of creating a false appearance of fact in furtherance of an overall scheme to defraud.” Otherwise, it would be easy for plaintiffs to disguise prohibited aiding and abetting claims as “primary violator” claims. Thus, because the “transactions involving AOL did not create a false appearance until they were viewed in conjunction with Homestore’s actions,” AOL was not liable under §10(b). Despite the dismissal, the court granted the plaintiff the opportunity to seek leave to file an amended complaint that could take advantage of the reasoning of its opinion. *Simpson v. AOL Time Warner Inc.*, 2006 WL 1791042 (9th Cir., 06/30/06).

## D.C. Circuit Overturns SEC Hedge Fund Rule

On June 23, 2006, the D.C. Circuit Court of Appeals set aside the SEC’s recent regulation of hedge funds under the Investment Advisers Act (“IAA”) of 1940 — the “Hedge Fund Rule,” that would have required hedge fund advisers to register with the SEC. Hedge fund advisers were previously exempt from registration under the IAA, though governed by other anti-fraud provisions of the Act, because they advised fewer than fifteen clients, a threshold for registration under the Act.

The Hedge Fund Rule, however, changed the method of calculating “clients” under the IAA. Under the SEC’s new math, each investor in the hedge fund was considered a client, as opposed to past practice where the fund itself was considered the client. Before the enactment of the Hedge Fund Rule, few hedge fund advisers were required to register because very few advisers advised

Continued from page 1

more than fifteen funds. After the new regulation, almost every hedge fund adviser would be required to register. Goldstein, a hedge fund adviser, brought the action on grounds similar to two dissenting SEC commissioners when the rule was issued.

The D.C. Circuit set aside the regulation as an arbitrary application of the IAA and congressional intent. The court found that the fifteen client threshold could not reasonably be interpreted to mean the investors in the hedge funds because the definition created fiduciary duty conflicts for fund advisers and conflicted with other statutory schemes.

However, the court left open the possibility that the SEC could formulate a new rule to require registration of a smaller subset of hedge fund advisers. The court stated that the recent trend in individualized hedge fund investment arrangements, including “different lock-up periods, greater access to information, lower fees, and ‘side pocket’ arrangements,” could create different classes of investors that might warrant treating some of the classes of hedge fund investors as clients. The court stated, “If there are certain characteristics present in some investor adviser relationships that mark a ‘client’ relationship, then the Commission should have identified those characteristics and tailored its rule accordingly.” However, because the current rule painted with such a broad brush, the current regulation was set aside. *Goldstein v. SEC*, Case No. 04-1434 (D.C. Cir., 6/23/06).

### Disney Defeats Breach of Fiduciary Duty Challenge for Ovitz’s \$30M Severance

On June 8, 2006, the Delaware Supreme Court affirmed that the Walt Disney Company breached no duty to its shareholders in paying Michael Ovitz \$130M for his 14-month stint

as President. Disney shareholders brought suit against the board, alleging breaches of fiduciary duty for approving the Ovitz employment agreement, its no-fault-termination (NFT) provision, and the actual NFT payment. The shareholders also brought suit against Ovitz for negotiating, and accepting, the NFT payment.

At the outset, the court held that fiduciary duties are imposed on directors and officers only while in office. Thus, Ovitz owed no duty to shareholders during negotiations. Nor did Ovitz have a duty to call a board meeting to renegotiate the NFT payment, an obligation Disney assumed prior to his taking office. As for the board, the court emphasized that authority may be delegated to committees and that the directors rightfully relied on the compensation committee’s approval of the severance package. The committee itself, although failing to observe “best practices,” was not grossly negligent.

The court also clarified the duty to act in good faith, an undeveloped area of corporate law. “Bad faith” may be conduct motivated by an actual intent to do harm or a conscious disregard for one’s responsibilities. It is not, however, gross negligence without any malevolent intent. The court affirmed all trial-court findings that neither Eisner, Ovitz, nor the board acted in “bad faith.” *In re Walt Disney Co. Derivative Litigation*, No. 411, 2005 (Del., 06/08/06).

### Supreme Court Limits Civil RICO, Again

The Supreme Court increased the bargaining power of defendants facing civil RICO suits last month by affirming a district court’s grant of a motion to dismiss RICO claims. The plaintiff in the district court action, Ideal Steel Supply Corp., sold steel products in Queens and the Bronx,

New York. National Steel Supply Inc. was a direct competitor in both markets. National allegedly failed to charge cash-paying customers sales tax, resulting in lower overall prices. Ideal alleged that this practice was designed to give National a competitive advantage and that National used the profits from the illegal scheme to open their Bronx location. The Court held that the RICO claims were too speculative and had only an attenuated connection to the defendants’ conduct. Stating that its decision did not create new law and that the decision was an application of the Court’s 1992 decision in *Holmes v. SIPC*, the Court held that the intervening effect of market forces and the fact that the State of New York was better suited to remedy the alleged illegal actions were fatal to Ideal’s suit.

Though the Court stated that it created no new law, the case is notable because the Court affirmed a motion to dismiss. Because the Court allowed dismissal at an early stage in the litigation, defendants in civil RICO cases have new authority to avoid the protracted legal battles that usually face civil RICO defendants. *Anza v. Ideal Steel Supply Corp.*, 126 S. Ct. 1991 (2006).

### Dept. of Labor Expands Whistleblower Protection

The U.S. Dept. of Labor Admin. Review Board (ARB) expanded SOX whistleblower protection in *Klopfenstein v. PCC Flow Technologies Holdings* by holding that the common law of agency should determine whether a private subsidiary or its employees may be agents of the publicly owned parent and, thus, subject to SOX liability. The ARB distinguished its holding in *Flake v. New World Pasta Co.*, where it held that the respondent’s private subsidiary was not a proper party under SOX, explaining that in *Flake*, there was no public parent. The Board stated that

SOX “did not require a complainant to name a corporate respondent that is itself ‘registered under §12 or ... required to file reports under §15(d),’ so long as the complainant names at least one respondent who is covered under [SOX] as an ‘officer, employee contractor, subcontractor, or agent’ of such a company.”

The Board further expanded whistleblower protection by stretching the definition of “protected activity” under SOX. In *Klopfenstein*, the complainant claimed he was discharged due to his investigation of discrepancies in in-transit inventory balances. Although he did not believe the discrepancies amounted to fraud, the Board held these discrepancies suggested at least “incompetence in [the employer’s] internal controls that could affect the accuracy of its financial statements.” Therefore, the discrepancies were “not clearly outside the realm covered by [SOX].” *Klopfenstein v. PCC Flow Tech. Holdings* (Dept. of Labor, ARB No. 04-149; ALJ No. 04-SOX-11, 5/31/06).

### **SEC Rejects SOX 404 Exemption For Small Companies After PCAOB Issues Internal Control Guidance**

The SEC has refused to exempt small public companies from the internal control reporting requirements in SOX 404. Section 404, first enacted in 2002, requires public companies to annually assess and publicly report on the effectiveness of their internal control over financial reporting. In April 2006, an SEC advisory committee recommended that smaller companies be exempt from §404 reporting requirements. The SEC rejected that recommendation, stating “ultimately all public companies will be required to comply with the internal control reporting requirements of Section 404.” However, the SEC also stated it would

issue a “concept release” covering a variety of issues to prepare for issuing further guidance on how company management can better assess internal controls over financial reporting. That would include the proper role of outside auditors in connection with management’s assessment of internal controls, and whether auditors can provide attestation about internal controls as a possible alternative to the current approach.

The SEC’s refusal to exempt small public companies from §404’s internal control reporting requirements came on the heels of the Public Company Accounting Oversight Board (PCAOB) announcement of a four-point plan to improve SOX internal control reporting provisions. SOX §404 requires public companies to annually assess and report on the effectiveness of their internal control over financial reporting. The PCAOB’s announcement targets Auditing Standard No. 2 (AS2), which establishes the professional standards for auditors when conducting an audit of internal control over financial reporting. To help clarify and refine those standards, the PCAOB stated it will: (1) Consider amending AS2 to ensure that auditors’ primary focus is on areas posing higher risk of fraud or material error, clarify the auditor’s role in evaluating the process that a company uses in assessing its internal controls, provide further guidance to auditors, and refine AS2’s definitions of what constitutes a “significant deficiency,” a “material weakness in internal control,” and “materiality”; (2) reinforce auditor efficiency through PCAOB inspections of registered public accounting firms, focusing on the firms’ efficiency in conducting internal control audits; (3) develop guidance and potential training opportunities for auditors of smaller public companies; and (4) hold eight forums during 2006 for the auditors, directors and financial

officers of smaller public companies in connection with auditing requirements. SEC Press Rel. 2006-75 (5/17/06).

### **SEC Approves Rules and Amendments for Fund of Funds Investments**

On June 20, the SEC adopted three rules and amendments under the Investment Company Act that address “fund of funds arrangements,” which occur when a mutual fund or other investment purchases shares of another investment company. The Act restricts these arrangements to prevent abusive “pyramiding” schemes. The new rules codify various exemptions from the Act that the SEC previously issued, and provide greater transparency of expenses to investors. Rule 12d-1-1 permits “cash sweep arrangements,” under which a stock or bond fund may invest available cash in a money market fund. Rule 12d-2 permits greater flexibility to a fund of funds arrangement that invests exclusively or primarily in funds in the same fund group. Rule 12d-3 permits enhanced flexibility for a fund that invests small amounts in unaffiliated funds to structure the sales load it charges. In addition, to increase transparency to investors, Amendments to Forms N-1A, N-2, N-3, N-4, and N-6 require a registered fund that invests any of its assets in another fund, including an unregistered fund like a hedge fund, to disclose in its fee table the cumulative amount of expenses charged by the fund and any fund in which it invests. 71 Fed. Reg. 123, at 36639 (6/27/06).

### **SEC Wins \$80M Ponzi Scheme Judgment**

The SEC has obtained final judgment against a number of participants in connection with their participation a Ponzi scheme arising out of the fraudulent business of Mx Factors,

LLC, BBH Resources LLC and JTL Financial Group LLC. Investors located across the U.S. and Mexico invested in Mx Factor notes, induced by representations that the investments would finance an account receivable collection business. The defendants guaranteed investors a return of 12% within 60-90 days of investment and represented that 70% of the receivables were backed by the government. In fact, no accounts receivable business existed, and the funds were used to finance a Mexican crab fishing business, pay previous investors, pay personal expenses, and fund the defendants' overseas bank accounts. The court ordered payment of civil penalties, disgorgement and prejudgment interest by Daniel Berardi, Jr. (\$11 million), Thomas Hawkesworth (\$11 million), Randall W. Harding (\$17 million) and Richard Harkless (\$42 million). *SEC v. Mx Factors, LLC*, Case No. EDCV-04-223-VAP (C.D. Cal.); SEC Lit. Rel. No. 19726 (06/13/06).

### SEC and Fannie Mae Reach \$400 Million Civil Settlement

The SEC and the Office of Federal Housing Enterprise Oversight ("OFHEO") reached a \$400 million civil settlement of SEC and OFHEO litigation and investigations. The settlement will not end investigations into top executives at Fannie Mae, the SEC said. In a 340-page report, released just before the settlement, OFHEO criticized all levels of management at Fannie Mae and conditioned settlement on various corporate governance reforms. The report was particularly critical of former Fannie Mae CEO Franklin Raines and former CFO Timothy Howard for their role in the allegedly fraudulent accounting, including Fannie's failure to comply with Statement of Accounting Standards ("SFAS") 91, which, according to the SEC, required recognizing loan fees, premiums and discounts as an adjustment over the

life of the applicable loans. The SEC said that the effect of the accounting fraud was that Fannie Mae hit their EPS targets and management realized maximum personal bonuses in 1998 and beyond.

Aside from top management, OFHEO said Fannie's former General Counsel Ann Kappler and outside auditors failed to detect and disclose serious weaknesses in policies and procedures at Fannie Mae. Further, OFHEO said Kappler initiated flawed investigations after insider Roger Barnes raised issues with Fannie Mae's accounting practices. OFHEO also said the auditor's failure to detect and disclose serious weaknesses in policies and procedures contributed to the unsafe conditions at Fannie Mae.

As of mid-July Fannie Mae still had not restated earnings as a result of the irregularities. Filings estimated that the restatement could be as much as \$10.6 billion in cumulative reduction of earnings through 2004. The SEC stated that the vast majority of this restatement is "a result of Fannie Mae's improper hedge accounting" under SFAS 133, between 2001 and 2004. *See OFHEO, Report of the Special Examination of Fannie Mae (5/06), available at <http://www.ofheo.gov/media/pdf/FNMSPECIALEXAM.PDF>.*

### Merck Executives Win Vioxx Dismissal for Failure to Show Demand Futility

A New Jersey federal judge recently dismissed a shareholder derivative suit by Merck & Co. shareholders who sought to hold the company's officers and directors responsible for the company's development and sale of Vioxx. In an unpublished opinion that focused on the pre-suit demand requirement for shareholder derivative litigation, the court dismissed all of the plaintiffs' claims, finding that the plaintiffs should have served

the board of directors with notice of their claims and allowed them the opportunity to take action.

Plaintiffs claimed that the defendant directors knew that Vioxx created significant cardiovascular risks, but nevertheless concealed that information while continuing to market and promote the drug. Merck pulled Vioxx from the market in September 2004, and has since been served with hundreds of lawsuits alleging it concealed the risks of Vioxx.

In response to a motion to dismiss, plaintiffs argued that making a demand on the board of directors would have been futile because the directors actively participated in and approved of Merck's plans to market and sell Vioxx, that they had reaped substantial financial gain from Vioxx sales, that they would have committed insider trading had a demand been pursued, and that they effectively conceded that presuit demand was not required when they appointed a special committee to review the company's actions before taking Vioxx off the market.

The court rejected plaintiffs' claim that the directors were "disabled" by the substantial financial gain they had received from the sale and success of Vioxx, concluding that the allegations about the directors' compensation were "conclusory at best" and that the insider trading allegations were likewise unsupported. The court also rejected the argument that the directors had effectively conceded bias by appointing a special litigation committee to investigate the company's handling of Vioxx, since the special committee was composed of disinterested and independent directors. Notably, the court dismissed all of the plaintiffs' claims without leave to amend, concluding that any attempt to do so would be futile. *In re Merck & Co. Inc. Derivative and ERISA Litigation*, 2006 WL 1228595 (D.N.J. 5/5/06).

## Raising “Specter of Potential Fraud” is Not Protected Whistleblower Activity

A federal court has dismissed a whistleblower’s complaint for failing to establish she had engaged in “protected activity” under SOX. The complainant was an in-house attorney for the defendant corporation. When her managers informed her she would become the corporation’s Compliance Officer, she reviewed Federal Sentencing Guidelines and determined that unless the corporation adopted a compliance program based on the Guidelines, the program would be “legally deficient.” She refused to head up such a program because of the “potential risk of violations.”

After her discharge, she argued that merely “raising the specter of potential fraud” constituted protected activity under SOX because “creating a sham compliance program would perpetrate a fraud against shareholders.” The court disagreed, holding that the “plain language” of the statute described protected activity as “providing information that is reasonably believed to ‘constitute a violation’ of one of the enumerated statutes or regulations” and that “constitute” should be “understood to mean an actual violation has occurred.” Because neither SOX nor the Sentencing Guidelines mandate a particular compliance program, the complainant could not have reasonably believed that not basing a compliance program on the Sentencing Guidelines could constitute fraud under SOX. *Bishop v. PCS Admin.*, Case No. C-04-1742 (N.D. Ill., 5/23/06).

## Former Gateway CEO Beats SEC in Earnings Scheme Suit

A California federal judge recently dismissed securities fraud charges against Jeffrey Weitzen, the former Chief Executive Officer of Gateway, Inc. The SEC had alleged that, in the third quarter of 2000, Gateway’s

senior management became aware of a gap between anticipated revenue and analysts’ expectations for the quarter. According to the SEC, Weitzen, along with the company’s CFO and controller, engaged in a scheme to close the gap through several transactions that would inflate revenue for the quarter. The SEC alleged that Weitzen was responsible for material misrepresentations in Gateway’s Form 10-Q for the quarter, and for statements made in an earnings press release for the

*[M]ere knowledge of the existence of the transactions “does not allow a reasonable fact-finder to draw an inference that Weitzen had knowledge of their impropriety, or was reckless in not knowing.”*

same period, regarding three of those transactions.

In granting Weitzen’s summary judgment motion, the court first found that because Weitzen did not sign Gateway’s third quarter Form 10-Q, the SEC could not impute any alleged misstatements in the 10-Q to Weitzen. As to the press release which Weitzen helped prepare, the court found a genuine issue of material fact as to whether statements made about two of the three transactions were material misrepresentations. The court concluded, however, that the SEC had not demonstrated that Weitzen had acted with the requisite scienter.

Although it was undisputed that Weitzen knew about the transactions, the court held that mere knowledge of the existence of the transactions “does not allow a reasonable fact-finder to draw an inference that Weitzen had knowledge of their impropriety, or was reckless in not knowing.” The court noted that Weitzen was not an accountant and no evidence had been submitted showing that he had any reason to have accounting expertise “sufficient to challenge the treatment given to any particular transaction.” According to the court, Weitzen’s knowledge of management’s desire to close the anticipated gap between revenue and analyst expectations was nothing but “common and sound business practice.” *S.E.C. v. Todd, Manza, and Weitzen*, 2006 WL 1564892 (S.D. Cal., 5/30/06).

## Loss Causation Theory Conflicts with Stock Price Movement, Class Rejected

A federal district court in California recently dismissed a securities fraud class action suit because the complaint’s theory of loss causation was inconsistent with the behavior of the company’s stock price. The claims were dismissed without prejudice so the plaintiffs could amend their complaint.

Several shareholders of Redback Networks, Inc., a telecom equipment company, filed a securities fraud suit against certain officers and directors of Redback. The suit alleged that the defendants engaged in a scheme to defraud the market, which ultimately injured those who purchased Redback stock during a four-year time frame. According to the plaintiffs, Redback had secured several large deals at the time of the IPO and thereafter through bribery and *quid pro quo* arrangements, and the company had touted those deals without disclosing their illicit nature. Plaintiffs alleged that once the SEC began investigating

one of the counter-parties to the deals, the illicit revenues to come to a halt, and Redback's stock price dropped significantly.

The court held that the complaint failed to adequately plead loss causation. Redback's stock price had already declined from \$100 per share to \$4 per share before the illicit revenues had halted and the SEC had begun investigating. Therefore, plaintiffs had not shown how their injury had been caused by the alleged fraud. However, the court stated that a valid claim might exist based on a further drop in the stock price from \$4. *In re Redback Networks, Inc., Securities Litigation*, Case No. 03-5642 (N.D. Cal., 03/20/06).

### Thompson Memo Held Unconstitutional

A District of New York court has declared unconstitutional the Department of Justice's policy of refusing to give companies "cooperation credit" if they pay legal fees of employees who are under investigation. The policy, adopted by the Thompson Memorandum, provides that that payment of legal fees may be held against a business entity "if the government views the payments as protection of 'culpable employees' or as evidence of a lack of full and complete cooperation." The court's ruling was issued in connection with motions filed when KPMG agreed to cut off payment of legal fees for indicted employees and to condition payment of any pre-indictment fees on the employee's cooperation with the Government. The court found KPMG made this agreement because of the prosecution's threat to examine KPMG and its payment decisions "under a microscope" per the Thompson Memo. Citing the tradition of indemnifying corporate officers and employees, the court called the criminal defendant's right

to fairness "fundamental," holding that the Government may not "coerce" a third party into withholding funds "lawfully available" for payment of legal fees. Because the Thompson Memo discouraged payment of legal fees in the face of state indemnification statutes, when there was no evidence of obstruction of justice, the Thompson Memo violated the criminal defendant's right to due process and interfered with his right to defend himself. *U.S. v. Stein*, S1-05 Crim. 0888 (S.D.N.Y., 6/26/06).

### PSLRA Requires Sanctions for Abusive Litigation

A federal appeals court, affirming in part and reversing in part the lower court's decision, held that abusive or frivolous litigation that violates Fed. R. Civ. P. 11(b) requires imposition of sanctions, even in a securities fraud case.

The plaintiff had invested approximately \$1.4 million with an investment service offered by defendant Wachovia Securities, Inc. Plaintiff sued Wachovia for securities fraud when he lost money on his investment. After the district court granted Wachovia's summary judgment motion, Wachovia invoked a provision of the Private Securities Litigation Reform Act of 1985 ("PSLRA"), arguing that the plaintiff's complaints and briefs violated Fed. R. Civ. P. 11(b). Although the district court found several Rule 11(b) violations, it did not impose any sanctions.

The Fourth Circuit Court of Appeals vacated the district court's order to the extent that it did not impose any sanctions. The appeals court held that the PSLRA requires sanctions in any private securities action where a party or lawyer violates Rule 11(b), noting the court "shall impose sanctions ... in accordance with Rule 11" language of the Act. When a lower court has found

Rule 11(b) violations but the sanctions proponent has not reached the threshold to qualify for presumed sanctions award amounts under the PSLRA, the lower court should choose an appropriate sanction consistent with Rule 11. The Fourth Circuit remanded the case so that the plaintiff's lawyers would be admonished. *Morris v. Wachovia Securities, Inc.*, 05-1217, 05-1281 (4th Cir. 05/17/06).

### SDNY Says Market-Timing Class Action Not Preempted by SLUSA

The Federal District Court for the Southern District of New York rejected Mutual of America Life Insurance Company's attempt to invoke the preemption provision of the Securities Litigation Uniform Standards Act ("SLUSA")—which requires class actions alleging fraud in the sale of certain securities to be litigated in federal court—to remove a class action based on allegations of market-timing. The suit concerns a single state law claim that Mutual of America breached its fiduciary duty to purchasers of one of its investment funds by permitting market timing to occur within the fund. However, the court ruled that the claim did not meet a condition of SLUSA's removal provision, which requires that the substance of the plaintiff's allegations be that the defendant misrepresented or omitted a material fact in connection with the purchase of a security.

Although the complaint did not explicitly allege any untrue statements or omissions of material fact, the defendants had argued that the plaintiff's claims were based on "implicit" allegations of misrepresentations. For example, the plaintiff had alleged that Mutual of America held itself out as an expert in long-term investments. The defendant argued this amounted to

an allegation that the defendant had misrepresented that it would protect potential investors from market timing. The court disagreed, refusing to read a “disguised allegation of non-disclosure” into every claim of breach of fiduciary duty which alleges that, because a defendant possessed expertise in its field, it was obligated to fulfill certain duties, which it ultimately failed to do. The case was remanded to state court. *Paru v. Mutual of America Life Ins. Co.*, 2006 WL 1292828 (S.D.N.Y., 5/11/06).

### Proxy Statement Claim on Bonuses Survives Dismissal

A federal shareholder derivative suit regarding proxy language about executive bonuses is moving forward after surviving a motion to dismiss. According to plaintiff, a shareholder of Intel Corporation, the proxy statement provided that if shareholders approved the bonuses under the program, the bonuses would be tax deductible, but if the bonuses were not approved, the bonuses would still be given but would not be tax deductible. Plaintiff alleged that this was a false or misleading statement because there would be no deduction under the tax code where the same benefits would be given, even if the shareholders did not approve the plan.

The defendants moved to dismiss for lack of subject matter jurisdiction, arguing that the matter was not yet ripe for review since no tax deduction had been claimed yet and the IRS had not yet ruled on the propriety of the deductions. The court rejected this argument, stating that a violation of Section 14(a) of the 1933 Act occurs when allegedly false or misleading statements are made. In addition, delaying the

action could cause the plaintiff to violate the relevant statute of limitations. *Seinfeld v. Barrett*, Case No. 05-298 (D. Del., 03/31/06).

### Improper Revenue Recognition Claims Survive as to Sonus, But Fail Against Executives

Sonus Network Inc., shareholders initiated litigation against the company, its CEO, and its former CFO, stemming from an allegedly improper revenue recognition scheme designed to “smooth out”

*In determining corporate scienter under 10(b), the court “look[s] to the state of mind of the individual corporate official or officials who make or issue the statement (or order or approve it or its making or issuance, or who furnish information or language for inclusion therein, or the like) rather than generally to the collective knowledge” of all corporate employees.*

Sonus’ revenues to paint a picture of steady, reliable company growth. According to plaintiffs, Sonus’ true revenue pattern was “characterized by ‘lumpy’ ordering patterns and high customer concentration,” but that Sonus’ reported revenues indicated predictable, sequential growth to mislead the market. Based on the accounting errors admitted in the restatement, including approximately \$52.9 million of premature revenue

recognition, the complaint alleged that Sonus and its management issued a series of misstatements regarding revenues and expenses as well as their conformance with accounting principles through the issuance of press releases, certifications of public statements, and filings with the SEC, including a Prospectus Supplement, which adopted the previously filed SEC reports that contained material misrepresentations.

Despite the restatement, the court dismissed the 10(b) claims against the Sonus executives, finding that the complaint failed to allege sufficient facts about revenue recognition practices to raise a strong inference of fraudulent intent. Although the inference of scienter was bolstered by admissions of weaknesses in the company’s internal controls, the claims against the executives failed because “the revenue misstatements could have resulted from negligent management oversight.” In contrast, court held that “For purposes of determining whether a statement made by the corporation was made by it with the requisite Rule 10(b) scienter we believe it appropriate to look to the state of mind of the individual corporate official or officials who make or issue the statement (or order or approve it or its making or issuance, or who furnish information or language for inclusion therein, or the like) rather than generally to the collective knowledge of all the corporation’s officers and employees acquired in the course of their employment.” After applying this standard to the complaint, the court refused to dismiss the 10(b) claim against the company because the requisite strong inference of scienter was imputed to the company through the knowledge of non-defendant

## 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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