STEPTOE & JOHNSON LLP

Corporate Fraud Defense Report

June 2006 Volume 1, Number 6

Contents

Milberg Weiss Indicted for Kickback Scam

Milberg Weiss Bershad & Schulman and two of its prominent partners have been indicted by a grand jury for allegedly engaging in widespread fee-sharing and kickbacks to induce plaintiffs to bring class-action and shareholder derivative suits. Milberg Weiss allegedly has received more than $216 million in attorney fees from roughly 150 lawsuits and has allegedly paid over $11.3 million in kickbacks. The 20-count indictment, which includes charges of conspiracy, obstructing justice, perjury, bribery, money laundering, and mail fraud, follows a guilty plea entered by Howard J. Vogel, one of the paid plaintiffs who participated in as many as 40 lawsuits. Vogel is the first of the named defendants to cooperate with the ongoing investigation and has forfeited most of the $2.5 million he received from Milberg Weiss.

The indictment alleges that friends of Milberg Weiss purchased securities with the expectation that the market values would drop, thereby positioning themselves to bring suit as lead plaintiffs. By allegedly getting a cut of the attorneys' fees, the indictment alleges, the paid plaintiffs "had a greater interest in maximizing the amount of attorneys' fees awarded to Milberg Weiss than in maximizing the net recovery to the absent class members or shareholders." The indictment further alleges that lawsuits filed by Milberg were then "settled in a manner that often would generate substantial attorneys' fees for Milberg Weiss, while concealing from the courts approving these settlements, and from the absent class members or shareholders on whose behalf the settlements were being negotiated, their secret and illegal kickback arrangements." Milberg Weiss then purportedly paid the plaintiffs a portion of the fees collected. In New York, it is illegal for attorneys to split fees with non-attorneys.

Class-action attorneys and plaintiffs have argued that the indictment is "unjust, misguided and misinformed," and Milberg is reported to have "categorically denied" the charges. *U.S. v. Milberg Weiss Bershad & Schulman, LLP*, 05-CR-587 (C.D. Cal., 6/23/05); *US v. Vogel*, 06-CR-320 (C.D. Cal., 4/28/06); DOJ Press Rel., 5/18/06; www.milbergweissjustice.com.

SEC Brings First AML Enforcement Action Against Securities Firm

On May 22, 2006, the SEC announced that it had sanctioned broker-dealer Crowell, Weedon & Co. (Crowell) in its first-ever AML enforcement action under the Patriot Act, for failure to properly document its customer identification program (CIP). According to the Commission, from October 2003 through April 2004, Crowell failed to follow the procedures for documenting actual customer identities outlined in its written CIP, which required that the firm verify the identity of new customers through specific non-documentary and documentary procedures, such as a public database search and reviewing government-issued identification. Instead, during this period, in which the firm opened approximately 2,900 new accounts, Crowell allegedly relied on its registered representatives' personal knowledge of the customers opening the accounts to verify the customers' identities. The SEC maintained that Crowell's failure to accurately document its CIP was a violation of Section

Continued Next Page

Continued from page 1

17(a) of the Securities Exchange Act of 1934 and Rule 17-8, which require broker-dealers to comply with certain record-keeping requirements under the Bank Secrecy Act, as amended by the Patriot Act, including establishing, documenting, and maintaining procedures for verifying the identities of customers opening new accounts. Without admitting or denying any of the SEC's findings, Crowell consented to the issuance of a cease-and-desist order to prevent any future violations. *In the Matter of Crowell, Weedon & Co.*, SEC Admin. Proc. No. 3-12300, 5/22/06; SEC Press Rel. 2006-78, 5/22/06.

SEC Approves PCAOB Accounting Rules on Ethics, Independence

The SEC has approved the PCAOB's rules concerning auditor independence and audit firms' provision of tax services to public companies. Under the rules, public accounting firms and associated persons must be independent of the audit clients throughout audit and engagement period. Auditors may not provide certain tax services to their clients, including: (1) services involving contingent fee arrangements; (2) tax marketing, planning, or advice in favor of treatments considered confidential under Rule 3501, or based on aggressive interpretation of tax laws and regulations; and (3) tax services to certain corporate managers who serve in financial oversight roles.

The rules also require the auditor to seek audit committee approval of certain tax services and imposes a duty to: (1) describe proposed tax services to the committee; (2) discuss the potential effects of the services on the auditor's independence; and (3) document the discussion with the committee.

The SEC also approved an ethics rule that codifies the principle that individual accountants can be held responsible when they knowingly or recklessly contribute to their firm's violation of legal, regulatory, or professional standards. SEC Rel. No. 34-53677, 4/19/06.

Morgan Stanley Investors' Class Action Preempted by SLUSA

Investors brought a state-court class action alleging breach of contract claims against securities broker

> *"Plaintiffs' claim [was] a securities fraud wolf dressed up in a breach of contract sheep's clothing" and was "a quintessential example of a fraudulent omission of a material fact under the securities laws."*

Morgan Stanley Dean Witter & Co. to for failing to provide objective research and recommendations on technology companies that the broker sought as clients for its investment banking services. Plaintiffs alleged that when they opened accounts with Morgan Stanley, they entered into a series of contractual agreements that imposed the rules of the NASD, NYSE, and other self-regulatory organizations, all of which require brokers to provide investors with objective research and recommendations. Plaintiffs claimed that the Morgan Stanley breached its contracts with them by purportedly failing to disclose conflicts of interest created by the broker's desire to provide investment banking services for companies reviewed by its analysts.

Consistent with the U.S. Supreme Court's recent *Dabit* decision, the court dismissed the case against Morgan Stanley, holding that the plaintiffs' common law breach of contract claim is preempted by the Securities Litigation Uniform Standards Act (SLUSA). The wool was not pulled over the court's eyes by plaintiffs' crafty attempt to describe the broker's conduct as a breach "of the standardized contracts with the Plaintiffs and Class members." Finding that SLUSA preempted the claim and required dismissal, the court observed that "Plaintiffs' claim [was] a securities fraud wolf dressed up in a breach of contract sheep's clothing" and was "a quintessential example of a fraudulent omission of a material fact under the securities laws." *Felton v. Morgan Stanley Dean Witter & Co.*, 2006 WL 1149184 (S.D.N.Y., 5/2/06)

No Primary 10b-5 Liability for Vendors' Role in "Sham" Advertising Scheme

The Eighth Circuit has affirmed the dismissal of Charter Communications stockholders' securities fraud action against cable-box vendors, Scientific-Atlanta and Motorola. Plaintiffs alleged Charter schemed to pay the vendors an additional $20.00 per cable-box in exchange for the return of the $20.00 as advertising fees. Plaintiffs alleged these "sham or wash transactions" lacked "economic substance" and that Charter improperly capitalized the $20.00 premium by "treating the returned advertising fees as immediate revenue," inflating its operating cash flow by $17 million.

The court rejected plaintiffs' claims that the vendors committed primary violations of Rule 10b-5(a) and (c)

by their participation in a scheme to defraud and by engaging in a "course of business which operates…as a fraud or deceit." The court instead determined that the vendors' alleged actions were not primary violations of 10b-5 because they did not issue misstatements relied upon by the investing public, nor did they have a duty to plaintiffs to disclose information useful in evaluating Charter's true finances. Instead, the court held that the claims were for nothing more than aiding and abetting and that under *Central Bank* this does not establish a private cause of action under 10b-5. Unaware of any case imposing 10b-5 liability on a company entering into an arms-length, non-securities transaction with an entity that used the transaction to publish false statements, the court noted such a rule would introduce uncertainty in everyday business dealings. *In re Charter Comm'n, Inc.*, No. 05-1974 (8th Cir., 04/11/06).

New Treasury Rule Requires Mutual Funds to Disclose Suspicious Transactions

A new Treasury Department rule that becomes applicable on October 31 requires mutual funds to report any suspicious transaction that aggregates at least $5,000 in funds or other assets. A mutual fund must file a Suspicious Activity Report with federal authorities when it "knows, suspects, or has reason to suspect" that the transaction involves funds derived from an illegal activity, is designed to evade regulations, has no apparent lawful purpose, or facilitates criminal activity.

The Rule immunizes mutual funds from liability for release of information during mandated disclosure, and extends that protection to voluntary disclosure of suspicious transactions that do not meet the requirements for mandated reporting, e.g., transactions less than $5,000. The rule also prohibits the fund from revealing to the suspected party that it notified law enforcement authorities. The Rule places the burden of reporting on the mutual fund, not its affiliates, but allows joint reporting when more than one fund is required to report a transaction.

If the mutual fund suspects financing of terrorism or on-going money laundering, it must also notify authorities by telephone. Mutual funds must file the report within 30 days, although under certain circumstances a 60 day period is allowed. Fed. Reg. 26,214, Final Rule (5/4/06).

CEO Held Liable For Fraud Despite Reliance on Accountants

Third Circuit has affirmed fraud liability imposed upon Ed Johnson, CEO of MERL Holdings, Inc., following a jury trial in an SEC enforcement action. The SEC claimed that Johnson engaged in a $25 million fraud scheme in which he caused his company to file fraudulent registration statements and press releases that artificially inflated the company's financials and omitted material information about his prior criminal conviction. The SEC also alleged that Johnson traded on inside information.

Johnson's main argument on appeal was that the evidence was not sufficient to "support a finding of a knowing or reckless violation" in part because he relied on MERL's accountants and auditors in filing the registration statements. The court disagreed, holding "Good faith reliance on the advice of an accountant or another professional has been recognized as a viable defense to scienter in securities fraud cases. . . . That defense is available, however, only when all pertinent facts are disclosed to the professional." Finding that Johnson failed to disclose material information to the auditors, the court concluded that there was ample evidence upon which the jury could have found Johnson reckless. The court also found that Johnson's failure to disclose his prior conviction in the registration statement was relevant to the SEC's misrepresentation claims and that the trial court properly admitted evidence about the circumstances of his prior offense. *SEC v. Johnson*, 2006 WL 869162 (3d Cir., 04/05/06).

Court Rules That Company Optimism Is Not Fraud

A federal court recently dismissed a securities class action against eSpeed Inc., ruling that the plaintiffs did not adequately allege that the bond trader tried to deceive them about problems with a new electronic trading product. eSpeed, a subsidiary of Cantor Fitzgerald Securities, provides institutional investors with a forum to trade government bonds electronically. In 2003, eSpeed introduced a software program designed to deliver better trade executions in exchange for higher commissions. The media reported that the new program was being received poorly, but eSpeed officials stated that the software would be successful. In 2004, eSpeed's share prices dropped, and the software was soon discontinued.

Shareholders filed a class action against eSpeed under §§10 and 20 of the 1934 Act and Rule 10b-5, alleging that eSpeed officials committed fraud through their public statements, and by failing to disclose that the software was unsuccessful. eSpeed filed a motion to dismiss, which the court granted. The court ruled that the alleged public misstatements by eSpeed officials were either puffery or covered by the "bespeaks caution" doctrine, which protects forward-looking statements accompanied by cautionary language. The court also held that the plaintiffs failed to adequately allege that eSpeed intended to deceive

them. The court held, "The fact that eSpeed introduced a new product that ultimately failed, despite cautious optimism from defendants … does not entitle eSpeed's investors to use federal securities laws as a 'scheme of investor's insurance.'" Although the complaint was dismissed without prejudice, the court noted its "grave doubts as to whether plaintiffs can ever allege facts sufficient to survive a motion to dismiss." *In re eSpeed, Inc. Securities Litigation*, 2006 WL 880045 (S.D.N.Y., 4/3/06).

J.P. Morgan Settles IPO Suit for $425 Million

J.P. Morgan Chase & Co. recently agreed to settle its portion of a class-action lawsuit for $425 million. The action was brought on behalf of investors against 55 investment banks, alleging that they defrauded investors of billions of dollars through initial public offerings that took place during the 1990s high-tech market frenzy.

J.P. Morgan was the first of the investment bank defendants to settle. The lawsuit contends that during the technology bubble, the banks gave shares of popular initial offerings to favored clients in exchange for financially rewarded investment banking work. The action also alleges that the banks structured deals with investors so that they would purchase shares in the aftermarket, which would artificially drive up prices. J.P. Morgan's settlement agreement requires court approval. *In re Initial Public Offering Securities Litigation*, 1:21-MC-00092 (S.D.N.Y., 04/20/06).

No Short-Swing Liability for Acquisition of Hybrid Options

The Second Circuit held that indirect acquisitions of hybrid "put" options do not run afoul of Section 16(b) of the 1934 Securities Exchange Act, which requires disgorgement of profits earned from short-swing trading. A hybrid option, which is an option that involves both fixed and floating pricing, is "sold" for the purposes of Section16(b) at the time that the option is granted, not when it is exercised, as long as it is exercised according to a fixed-price mechanism. The court based its decision on a combination of Sections 16b-6(a) and -6(b), which state that the establishment of a put option position is a sale of the underlying securities for purposes of Section 16(b), and that the disposition of underlying securities at a fixed price due to the exercise of a put equivalent position shall be exempt from Section 16(b) of the Act.

> *"[D]uring the technology bubble, the banks gave shares of popular initial offerings to favored clients in exhange for financially rewarded investment banking work."*

In a question of first impression, the court also held that for purposes of Section 16(b), insider acquisition of stock by acquisition of a third-party intermediary company does not give rise to Section 16(b) liability. "Section 16(b) does not take account of transactions in which an insider's acquisition of an enterprise holding the issuer's stock entails appreciable risks and opportunities independent of the risks and opportunities that inhere in the stock of the issuer." *At Home Corp. v. Cox Communications Inc*, 2006 WL 1148512 (2d Cir, 5/1/06).

SDNY Rules in Favor of Director in Short-Swing Profit Case

The District Court for the Southern District of New York has dismissed a Section 16 lawsuit for disgorgement of short-swing profits against a director of Centillium Communications, Inc. The director had entered into a variable prepaid forward contract with CSFB Cayman International LDC ("CSFB") on November 9, 2001. A "variable prepaid forward" transaction "is a contract entered into by an insider with a counterparty under which the insider contracts to sell a fixed number of shares of stock of the insider's company on a fixed future date at a fixed price." Under the contract, CSFB paid approximately $5.31 per share for 300,000 shares of Centillium stock, with the shares to be held in trust and transferred to CSFB on January 12, 2005. On January 7, 2005, Centillium stock closed at $2.38 a share, and the director transferred the shares to CSFB. Then, on February 28, 2005, the director purchased 162,814 shares of Centillium stock on the open market for $2.01 a share. The plaintiff brought a derivative action on behalf of Centillium against the director, seeking disgorgement of the gains on the February 2005 stock purchase because it was made within six months of the January 2005 transfer of shares to CSFB under the variable prepaid forward contract. The court ruled in the director's favor, finding that the transaction occurred in 2001, not in January 2005 when the shares were transferred to CSFB. Accordingly, any gains on the February 2005 purchase were not short-swing

gains under Section 16. *Donoghue v. Centillium Communications, Inc.*, 2006 U.S. Dist. Lexis 13221, No. 05 Civ. 4082 (WHP) (3/28/06).

Failure to Plead Demand Futility Kills Derivative Suit

A federal district court recently dismissed a shareholder derivative suit against Carrier Access Corp. because the plaintiffs failed to adequately plead futility of demand on the board of directors, as required by Delaware law. Plaintiffs alleged that board members on Carrier's audit committee failed to take necessary action to implement adequate internal accounting controls, resulting in false financial statements which overstated the company's growth and profitability and did not adhere to GAAP. According to plaintiffs, this initially caused Carrier's stock price to skyrocket, but then crash upon discovery of the misstatements.

The court dismissed the lawsuit, however, finding that plaintiffs had not properly alleged any "particularized facts creating a reasonable doubt that a majority of the Board would be disinterested *or* independent in making a decision" on a demand to the board of directors. The court held that plaintiffs' allegation that Carrier had an audit committee and that the independent outside director defendants were members of this committee during the period when the accounting improprieties occurred "is not enough." The court further held that the plaintiffs had failed to present facts showing that over half the committee members were dominated or controlled by anyone else. They offered nothing to show any substantial business or personal relations that might question their independence. *Kenney v. Koenig*, 2006 WL 845855 (D. Colo., 03/30/06).

SEC Lawsuit Against Ex-Citigroup Officials Survives Motion to Dismiss

The U.S. District Court for the Southern District of New York denied a motion to dismiss a suit against two ex-Citigroup officials for aiding and abetting a fraud against mutual fund investors. Citigroup Asset Management (CAM) officials convinced an investor board to approve a transfer agent contract which diverted over $100 million in transfer agent fee discounts from investors to a CAM affiliate. After succeeding in an action against CAM, the SEC filed suit against the two officials who allegedly proposed and orchestrated the plan.

The court refused to dismiss the SEC's lawsuit even though it had been filed after the expiration of the five year statute of limitations. The Court reasoned that, because the officials' failure to disclose vital information to the board was "inherently self-concealing," the statute of limitations was tolled until the SEC discovered the fraud in 2003.

The court also rejected the defendants' argument that the SEC had not adequately alleged an aiding and abetting claim. The court found that the SEC's allegations that the two officials instructed subordinates to develop a fraudulent plan, knew the material facts and true nature of the plan, and did not disclose it to the board stated an aiding and abetting claim. *SEC v. Jones*, WL 1084276 (S.D.N.Y., 04/25/06).

Fraudulent "Asset Protection Program" Leads to $32M Consent Order

Ronald Holt and three companies he controlled have entered into a $32 million consent agreement with the CFTC, representing $14.4 million in restitution, $1.5 million in interest, and $16 million in penalties, for allegedly running a fraudulent "asset protection program" in violation of the Commodities Exchange Act. Between 1997 and 2003, Holt allegedly defrauded 2,500 investors of $25 million through illegal off-exchange futures contracts. The investment scheme promised substantial returns and little risk by trading in foreign currency and precious metals, but Holt never purchased any commodities. Instead, he allegedly diverted the funds to personal use and misled investors with periodic reports of false profits and account balances.

The CFTC, SEC, and a court-appointed receiver have been working to recover assets from Holt and the companies he managed. Of the original $25 million, only about $1.5 million has been recovered. Holt has been in jail for civil contempt since July of 2004 because he has refused to account for the rest of the missing money, including $3 million he admittedly transferred offshore. Holt has agreed to permanently refrain from soliciting funds for commodity interest contracts and from trading in futures. *CFTC v. Holt*, Civ. No. 03-1826 (D. Ariz.); CFTC Press Rel., 4/11/06.

Tyco Agrees to Pay $50M to Settle SEC Charges

Tyco International Ltd. will pay a $50 million fine to settle SEC charges that it used improper accounting practices to overstate its financial results by at least $1 billion from 1996 through 2002. The Commission's complaint alleged that Tyco (1) inflated its operating income by at least $500 million as a result of improper accounting practices relating to hundreds of companies it acquired; (2) inflated its operating income by $567 million by means of connection fees that ADT Security Services, Inc., a

subsidiary of the company, charged to dealers from whom it purchased security monitoring contracts; (3) failed to disclose certain executive compensation and indebtedness, as well as related party transactions of its former senior management; (4) incorrectly accounted for certain executive bonuses; (5) violated the antibribery provisions of the Foreign Corrupt Practices Act; and (6) made false and misleading statements in its SEC filings and public statements as a result of these various practices.

Two former Tyco executives implicated in the fraud – L. Dennis Kozlowski, the former chairman of the company, and Mark H. Swartz, the former chief financial officer – were both convicted in state court in 2005 of grand larceny, conspiracy, securities fraud, and falsifying business records. They were sentenced to 8 1/3 to 25 years in prison and ordered to pay close to $240 million in fines and restitution. Both men are appealing their convictions. *SEC v. Tyco International Ltd.*, 06 CV 2942 (S.D.N.Y.); SEC Press Rel., 4/17/06; SEC Lit. Rel. 19657, 4/17/06.

SEC and Watchdog Battle Over FOIA Request

In 2004, SEC Insight Inc. (Insight), a Minnesota research corporation that uses FOIA requests to obtain information about public companies, sued the SEC in federal district court over the Commission's denial of 26 FOIA requests for records about inquiries or investigations into certain public issuers. The litigation is now stalled over whether the SEC is required to conduct a document-by-document review of six investigatory files responsive to Insight's FOIA request, and if so, who will pay for the cost of conducting the review. In October 2005, the court ordered the SEC to review Insight's request for data on several companies that may still be under investigation, holding that the SEC could not claim a FOIA exemption without a thorough review of the documents. The court declined to reconsider this decision in an order issued in January. In March, the SEC asked the court to certify the document review issue for interlocutory appeal, arguing that it would require the work of more than 30 attorneys to review the requests at a cost of approximately $2 million. The SEC also argued that the court's January order directing the Commission to conduct the review without requiring Insight to pay anything, inappropriately shifts the cost to the SEC, contrary to the intent of FOIA. The court denied the SEC's request for certification, and in late March, the SEC appealed the January order to the Eighth Circuit under the collateral order doctrine. Meanwhile, litigation on the cost-of-review issue continues before the district court. *J. Patrick Gavin v. SEC*, 04-4522 (D. Minn.); *J. Patrick Gavin v. SEC*, 06-1917 (8th Cir.).

CAFA Exceptions Defeat Class Action Removal

A federal district court has remanded a proposed class action brought against the directors of Delaware-incorporated Albertson's Inc. for alleged breach of fiduciary duty in selling the company to a consortium of buyers for $15 billion. Albertson's removed the case to federal court under the Class Action Fairness Act ("CAFA"), but plaintiff argued that the Complaint contained two types of claims excepted from CAFA removal: (1) internal corporate governance claims arising under the law of the state of incorporation, and (2) claims involving fiduciary duties relating to any security.

To fit within the first mandatory removal exception, Plaintiff dismissed claims under Idaho law, but maintained claims under Delaware law. The court found this unnecessary because the second exception warranted remand. Albertson's argued, however, that because all claims relating to the governance of a corporation are "grounded on a breach of fiduciary duty," the second exception would swallow the first. The court disagreed, stating that there are a "wide variety of claims" relating to corporate governance that do not require the establishment of a fiduciary duty relating to any security, but here the two types of claims intersected, justifying remand. *Carmona v. Bryant*, No. CV-06-78-S-BLW (D. Idaho, 04/19/06).

Hedge Fund Whistleblower Claim Subject to NASD Arbitration

The Second Circuit recently held that a Form U-4 required a hedge fund to arbitrate its former employee's Sarbanes-Oxley whistleblower claim. In 2003, Charles Schaffran was terminated by the hedge fund Alliance Bernstein Investment Research and Management, Inc., LP (Alliance). As part of his employment with Alliance, Schaffran executed a Form U-4, "Uniform Application for Securities Industry Registration or Transfer." The form contained an arbitration clause mandating that disputes "between me and my firm . . . be arbitrated under" applicable NASD rules.

In September 2004, Schaffran filed a claim with the NASD to initiate arbitration proceedings against Alliance, claiming he was fired for cooperating with government and private attorneys investigating alleged wrongdoing by Alliance, who filed for declaratory judgment in federal court, arguing that it was not required to arbitrate the SOX claims. The district court rejected Alliance's claim. On appeal, the Second Circuit did not reach the question of whether the SOX claim was arbitrable, ruling that the issue should be decided by an arbitrator. Although the Federal Arbitration Act presumes that courts decide threshold questions of arbitrability, NASD

Rule 10324 provides that arbitrators are "empowered to interpret and determine the applicability of all provisions" under the NASD Code of Arbitration Procedure. By agreeing to be bound by the NASD rules, the court held, the parties manifested a clear intent that disputes over interpretation of NASD Code rules will be decided in arbitration, which overcomes the presumption that courts decide the initial question of arbitrability. *Alliance Bernstein Investment Research & Mgmt., Inc. v. Schaffran*, 445 F.3d 121 (2d Cir. 2006).

Arbitrator Must Decide Dispute Over Accounting Methods

A Delaware court recently held that a legal arbitrator, not an accountant, must resolve a dispute over the appropriate accounting method that should be used to calculate the contractual purchase price of a medical products and services provider. In 2004, OSI Systems, Inc. contracted to buy Spacelabs, a subsidiary of Instrumentarium Corp. The parties initially set the price at $57.3 million, but agreed to adjust the price at closing based on the change in value of Spacelabs' working capital. The contract initially valued Spacelabs' working capital at $85.1 million. At closing, however, Instrumentarium valued its working capital at $82.2 million, while OSI valued it at $54.36 million. The difference primarily resulted from differing accounting methods used by the parties.

The contract provided that price disputes would be arbitrated by an independent accountant without a damage limit. All other claims would be resolved by a legal arbitrator, and those claims would be subject to a damage cap of 25% of the purchase price. The Delaware court held the parties' dispute over the appropriate accounting method to use to value working capital at the time of closing was not a "price dispute" to be arbitrated before an independent accountant. The parties' dispute was rather a dispute over the method of calculating the price and, as such, was similar to a claim for breach of representation or warranty of value that the parties had agreed would be resolved by a legal arbitrator, subject to the damage cap. *OSI Systems v. Instrumentarium Corporation*, 892 A.2d 1086 (Del. Ch., 03/14/06).

The court held that the shareholders' claim implicated "if anything, a classic allegation of self-dealing or waste," but did not challenge the alleged excessive compensation "on duty of loyalty grounds."

Delaware Rejects Attempt to Recast Director Compensation as Dividends

A Delaware court has dismissed, with prejudice, a shareholders' claim that attempted to recast allegedly excessive executive compensation as a "constructive or '*de facto*' dividend" to which plaintiffs, as shareholders, would have had a right to share in equally. The court, noting that the "*de facto* dividends theory" was an attempt to apply tax law to corporate law, stated that no Delaware court has ever adopted such a theory, nor to its knowledge ever recognized that such a cause of action exists for the benefit of shareholders. The court held that the shareholders' claim implicated, "if anything, a classic allegation of self-dealing or waste," but did not challenge the alleged excessive compensation "on duty of loyalty grounds." The court granted the shareholders leave to amend the complaint to plead breach of loyalty. The court also held that the shareholders had been denied their statutory right to inspect the corporation's books and records and directed defendants to allow the shareholders to do so. *Horbal, et al. v. Three Rivers Holdings, Inc.*, 2006 WL 668542 (Del. Ch., 3/10/06).

Class Action Dismissed for Flaws in Loss Causation Pleading

A proposed securities fraud class action suit was dismissed in Florida because plaintiffs' pleading did not sufficiently allege that defendant's "fraud, as opposed to poor market conditions, was the proximate cause of TECO's stock price decline." The court held that the pleading insufficiently alleged loss causation because it failed to allege that a "misstatement or omission by Defendants concealed something from the market and that when information related to that fraud was disclosed, the value of their securities were [sic] effected." Despite a 164-page complaint, the court found that the plaintiffs' broad, vague allegations regarding revelations of fraud or improper accounting practices were not sufficient to put defendants on notice of the plaintiffs' loss causation claims. The dismissal was without prejudice. *In re TECO Energy Inc. Securities Litigation*, M.D. Fla., Case No. 8:04-CV-1948-T-27EAJ, 3/30/06.

The Corporate Fraud Defense Report™

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

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

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

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

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

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

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

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

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

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

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

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

STEPTOE & JOHNSON LLP
1330 Connecticut Avenue, NW
Washington, DC 20036

Presorted Standard
US Postage
PAID
Phoenix, AZ
Permit No. 4594