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GENERAL NEWS

Cox Resigns as Chair of a Battered SEC; Shapiro Nominated to Replace Him

On January 20, 2009, Christopher Cox resigned as chair of the Securities and Exchange Commission (SEC). President Barack Obama nominated Mary Shapiro, CEO of the Financial Industry Regulatory Authority (FINRA), to succeed Cox. Shapiro was approved unanimously by the Senate on January 22, 2009. Before Cox resigned, the SEC faced much criticism from investors and lawmakers because of its perceived lack of forceful behavior against Wall Street wrongdoers. The SEC received criticism in March 2008 when Bear Stearns collapsed and had to be bailed out by the Federal Reserve. Its image suffered further in September 2008 when Lehman Brothers filed for bankruptcy, Merrill Lynch was sold to Bank of America, and Goldman Sachs Group became regulated by the Fed. Then, in September, Cox prohibited short-selling the stock of banks, securities firms, and insurance companies. This angered hedge funds, which thought the action helped companies that

were failing because of their own poor decision-making. Cox later said that decision was the biggest mistake during his term as chairperson. A final setback occurred when Cox acknowledged that the SEC failed to detect Bernard Madoff’s alleged major fraud scheme even though it had received “credible and specific” accusations about Madoff for years. In December Cox stated he was disturbed that his staff did not do more to investigate Madoff’s alleged activities. Robert Hillman, a securities law professor at the University of California stated, “He was slow to recognize the deteriorating position of brokerage firms. In that sense, he bears joint responsibility with the Secretary of the Treasury and the Federal Reserve chairman.” At Shapiro’s confirmation hearing, she promised to take the “handcuffs off” the SEC’s enforcement division and go full force against anyone who violates investors’ trust.

Study Looks at the Effect of Pleading Standards on Forum Shopping in Securities Class Action Litigation

James D. Cox from the Duke University School of Law, Randall Thomas from the Vanderbilt Law School, and Lynn Bai from the University of Cincinnati College of Law studied the effects of the U.S. Supreme Court decision in *Tellabs* on fraud pleading and whether the plaintiffs’ attorneys in securities class action litigation select court venues based on that court decision. In the *Tellabs* case (which will be discussed further in the *Cases of Interest* section of this issue), the court said that plaintiffs must “state with

particularity facts giving rise to a strong inference that the defendant acted with the required state of mind”—in other words, with scienter. The authors wanted to determine if this decision and the pleading standards of other circuits affect how the plaintiffs’ attorneys choose the court venue. Federal appellate courts have varying standards for pleading fraud in securities class action cases. Based on this information, pleading standards might affect how the plaintiffs’ attorneys choose a court venue. However, the study’s authors found

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that other factors play a greater role in this decision-making process. The plaintiffs' attorneys want to file their case in the most favorable circuit and want to choose a venue that will help them win their case and receive the highest monetary judgment possible. However, in securities class action cases, the plaintiffs will most likely file suit in the defendant's home circuit because the defendants have almost always been successful in their motion to relocate a suit to their home venue. The study found that 85 percent of securities class action cases are filed in the

defendant's home circuit. Cases that are filed outside the home venue include those with low monetary values and do not have an accompanying SEC investigation. Another important factor in deciding on a court venue seems to be convenience in legal representation. Of 34 cases that were not filed in the defendant's home jurisdiction, 14 were filed in a jurisdiction of one of the plaintiff's law firms. Therefore, a court's pleading standards do not seem to have an impact on the plaintiff attorneys' decisions when choosing a court venue.

Study Documents Impact of Large Shareholders

Henrik Conqvist and Rüdiger Fahlenbrach of Ohio State University's Finance Department published a study demonstrating the influence that large shareholders, termed "blockholders" in the study, have on corporate policies. There are several ways in which large blockholders can influence corporate policies, including the election of directors, voting on corporate structure changes, and negotiating with the company's management team. Even though a company technically does not have to abide by the wishes of its large blockholders; if it does not, the company's executives could lose their jobs. The authors do not focus on the difference between large blockholders and individual shareholders, but instead look at the difference among large blockholders themselves. The study finds that large shareholders are not all the same in terms of their influence on corporate

policy. The authors examined the concept of blockholder "heterogeneity" and found it to be considerable among large blockholders. Large blockholders are different in their attitudes toward corporate investment and growth and CEO compensation. Some have a hard-hitting financial style, while others have a hard-hitting investment style. There are also certain groups of blockholders that have a greater influence on corporate policies—those with more power and monitoring capability (i.e., those with board representation) and those with one lone decision maker. Activist and pension fund blockholders have considerable influence over all of the corporate policies the authors studied—R&D, financial policies, and CEO compensation—while mutual fund blockholders have a strong effect on investment and financial policies.

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Alleged Insider Trading at an All-time High in 2008

In 2008, the number of alleged insider trading incidents hit an all-time high. The New York Stock Exchange Regulation, the regulatory arm of the NYSE, forwarded 146 potential insider trading cases to the SEC last year. This was five more cases than in 2007 and more than double the number of cases in 2004. The increase in cases related to material information about a security being exchanged and then used in violation of fiduciary duty. Hedge funds, which are typically

involved in several insider trading cases, played a smaller role in 2008 than in previous years, with a little more than half of the cases in 2008 pertaining to hedge funds versus 72 percent of the cases in 2007. This might have been the result of an overall reduction in the size of the hedge fund sector. The NYSE Regulation also noticed certain insider trading trends in 2008, including peaks in volume in the last minutes of daily trading and large price fluctuations during the middle of the

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day. Once the NYSE Regulation forwards a matter to the SEC, it is fully investigated. The SEC said that it issued 25 percent more insider trading enforcement actions in 2008 than in 2007. One of the last memorable spikes in insider trading was during the late 1980s, when Michael Milken was indicted for securities fraud. There were fewer cases in 1990, but the number began to rise again over the past five years. Some

believe this could be due to the fact that today's traders were still quite young when insider trading was more prevalent in the 1980s. John Malitzis, executive vice president of market surveillance at NYSE Regulation stated, "When a new generation comes up that wasn't front row to the lessons of the late '80s, they think it's easy to do and no one's going to catch them."

CASES OF INTEREST

U.S. Supreme Court Rules Employee that Cooperated in Investigation Is Protected from Retaliation Under Title VII

This Supreme Court case arose out of an internal investigation by a school district concerning rumors of sexual harassment by the district's employee relations director. During the district's investigation into the matter, the plaintiff, who is also a district employee, reported she had been sexually harassed by the director. The district took no action against the director but soon thereafter fired the plaintiff for alleged embezzlement. The plaintiff filed suit under Title VII of the Civil Rights Act of 1964 claiming retaliation for her report of harassment, in violation of 42 U.S.C. §2000e-3(a), which makes it unlawful "for an employer to discriminate against any...employe[e] who (1) "has opposed any practice made an unlawful employment practice by this subchapter" (opposition clause), or (2) "has made a charge, testified, assisted, or participated in any manner in an investigation, proceeding, or hearing under this subchapter" (participation clause). The trial court granted summary judgment for the district and the 6th U.S. Circuit Court of Appeals affirmed holding that the plaintiff could not bring her claim under Title VII because she could not satisfy the "opposition clause" since she had not "instigated or initiated any complaint," but had "merely answered questions by investigators in an already-pending internal investigation, initiated by someone else." The courts found that the

opposition clause demanded "active, consistent" opposing activities, whereas the plaintiff had not initiated any complaint prior to the investigation, and found that the participation clause did not cover the district's internal investigation because it was not conducted pursuant to a Title VII charge pending with the Equal Employment Opportunity Commission. The Supreme Court reversed the lower court's holding that the Title VII anti-retaliation protection extended to an employee who speaks out about discrimination, not on ones own initiative, but in answering questions during an employer's internal investigation. The court reasoned that because "oppose" is undefined by statute, it carries its ordinary dictionary meaning of resisting or contending against, and the plaintiff's statement was thus covered by the "opposition clause" as an ostensibly disapproving account of the director's sexually obnoxious behavior toward her. The court found that "oppose" goes beyond "active, consistent" behavior in ordinary discourse and may be used to speak of someone who has taken no action at all to advance a position beyond disclosing it. The court noted that nothing in the statute required a rule protecting an employee who reports discrimination on ones own initiative, but not one who reports the same discrimination in the same words when asked a question. The Supreme

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Court stated that the 6th Circuit's rule could undermine the statute's "primary objective" of "avoid[ing] harm" to employees for if an employee reporting discrimination in answer to an employer's questions could be penalized with no

remedy, prudent employees would have a good reason to keep quiet about Title VII offenses. *Crawford v Metropolitan Government of Nashville and Davidson County*, ___ U.S. ___. Decided January 26, 2009.

LLC Is Not a "Subsidiary Corporation" Under Crime Policy; Therefore Loss Is Not Covered and Insured Is Not Entitled to "Reform" the Policy

This is an insurance dispute between AEP and its insurer, Affiliated FM Insurance Company (Affiliated), under a policy covering AEP and its subsidiaries from loss due to employee theft or misconduct. AEP discovered losses that occurred in 1999 due to employee theft at two subsidiary limited liability companies (LLCs). AEP claimed that these losses were covered under the policy's "prior loss" clause, which provided coverage for earlier losses if those losses would have been covered under an insurance policy in existence at the time. For purposes of the appeal, the parties agreed that the policy covered the losses if the then existing Chubb policy would have extended coverage at that time. Affiliated denied coverage based upon the "subsidiary" language of the policy that provided coverage extension for "any subsidiary *corporation* now existing or hereafter created or acquired." (Emphasis added.) Affiliated took the position that this language limited coverage to true corporations and excluded other subsidiary entities like the two LLCs. AEP contended that the policy was ambiguous and that the term "subsidiary corporation" could reasonably be interpreted to include LLCs. AEP argued that the common understanding of "corporation" extended beyond its legal definition and included unincorporated entities like LLCs. AEP also pointed to numerous judicial and legal references to LLCs as "limited liability corporations." AEP further argued that the term must be construed in light of the overarching policy and interpreting the policy to exclude LLCs would create an "absurd consequence—an inexplicable gap in insurance coverage" among subsidiary entities. The court, applying Louisiana

law, rejected AEP's arguments and held the generally prevailing meaning of the term "corporation" did not include LLCs and that LLCs are statutory creatures defined in part by their contrast to corporate entities. Alternatively, AEP also sought to have the court "reform" the policy to include LLCs. Reformation is an equitable remedy used to correct errors or mistakes in contracts. An insurance policy generally may be reformed if, through mutual error or fraud, the policy as issued did not express the agreement of the parties. The party seeking reformation has the burden to establish a mutual error in the creation of a contract. The court noted that even in the event of a mutual error, reformation may be inappropriate if the rights of third parties are affected. The court refused to reform the Chubb policy because Affiliated, who was not a party to the original agreement, had no knowledge of any "error" in the Chubb policy when it later assumed liability through the Affiliated policy. The court also found that use of the term "corporation" is not the type of "error" that reformation is intended to remedy. The court noted there was no allegation that Chubb and the insured made a clerical error in using the word "corporation." Rather, AEP argued that the original parties had a broader-than-usual meaning in mind when they purposefully included the word "corporation." The court characterized the argument by stating, "In effect, AEP attempts to make an end-run around the parol-evidence rule by framing its argument as a request for reformation. We will not sanction such a strategy." *American Elec. Power Co. Inc. v. Affiliated FM Ins. Co.*, --- F.3d ---, 2009 WL 130187 (C.A.5).

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Arbitration Provision in D&O Policy Requires Bad Faith Claim Must Be Arbitrated

At issue was whether the bad faith claim was within the scope of the arbitration agreement.

BCS Insurance (BCS) issued a Directors' and Officers' liability insurance policy to the insured, Independence Blue Cross (IBC). During the period of coverage, IBC was sued for alleged improper negotiation and performance of contracts. After the lawsuit settled, the insured filed a claim seeking indemnity for its incurred defense expenses. BCS subsequently denied coverage. In the insurance policy, the parties agreed to binding arbitration of "Any controversy arising out of or relating to this Policy or the breach thereof..." The insured initiated arbitration proceedings to determine the right to indemnity for the expenses incurred in defending the underlying action. It also indicated an intent to pursue a bad faith lawsuit in court. BCS filed this action to compel arbitration of both the coverage and the bad faith claims based upon the language in the policy. At issue was whether the bad faith claim was within the scope of the arbitration agreement. The insured's position was that the

bad faith claim qualified as separate and distinct matter because it involved BCS's behavior. It claimed that such behavior is not contemplated by the policy and therefore outside of the scope of arbitration. BCS argued that bad faith claims must be arbitrated by virtue of the breadth of the underlying arbitration provision and that the bad faith claim would not arise but for the contract. The court agreed and ordered all matters arbitrated. Applying Pennsylvania law, the court reasoned that since the language, "any controversy arising out of or relating to this Policy" contained in the arbitration provision contemplated any question that may arise, it was broad enough to encompass a bad faith claim. The court concluded that the insured had failed to overcome the strong presumption of arbitrability and the bad faith claim would therefore have to be resolved in arbitration. *BCS Insurance Co. v. Independence Blue Cross, et al*, 2009 WL 102978 (N.D.III.).

9th Circuit, Applying *Tellabs*, Rules that a Dual Inquiry of Allegation of Scienter Is Required when Ruling on a Motion to Dismiss

*In reviewing *Tellabs*, the court concluded that a court must determine whether "all of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard."*

In 1995, the Private Securities Litigation Reform Act (PSLRA) amended the Securities Exchange Act to require that a complaint plead with particularity, scienter. Since then, various courts have come up with differing applications of the law. To adequately plead scienter, the complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." The Supreme Court recently defined "strong inference" in *Tellabs* (as reported in the *June 2007 Month in Review* and *June 2007 Advisor*), concluding that a securities fraud complaint will survive a motion to dismiss under Federal Rule of Civil Procedure 12(b)(6), "only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." Thus, a court now reviewing a complaint's scienter allegations under the PSLRA must "consider the complaint in its

entirety, as well as other sources courts ordinarily examine when ruling on motions to dismiss, in particular, documents incorporated into the complaint by reference, and matters of which a court may take judicial notice." In reviewing *Tellabs*, the court concluded that a court must determine whether "all of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard." Finally, when "determining whether the pleaded facts give rise to a 'strong' inference of scienter, the court must take into account plausible opposing inferences." This "inquiry is inherently comparative." A court must compare the malicious and innocent inferences cognizable from the facts pled in the complaint, and only allow the complaint to survive a motion to dismiss if the malicious inference is at least as compelling as any opposing innocent inference. In its decision,

CASES OF INTEREST (CONT.)

the 9th U.S. Circuit Court of Appeals stated:

We read *Tellabs* to mean that our prior, segmented approach is not sufficient to dismiss an allegation of scienter. Although we have continued to employ the old standards in determining whether, a plaintiff's allegations of scienter are as cogent or as compelling as an opposing innocent inference...we must also view the allegations as a whole. Thus, following *Tellabs*, we will conduct a dual inquiry: first, we will determine whether any of the plaintiff's allegations, standing alone, are sufficient to create a strong inference of scienter; second, if no individual allegations are sufficient, we will conduct a

“holistic” review of the same allegations to determine whether the insufficient allegations combine to create a strong inference of intentional conduct or deliberate recklessness.

Whether this dual inquiry, which appears to afford plaintiffs two attempts to meet the pleading requirements, will have any practical effect is difficult to predict. The 9th Circuit panel held that scienter was inadequately plead in the complaint even when evaluated holistically, with the court noting that “a comprehensive perspective of Zucco’s complaint cannot transform a series of inadequate allegations into a viable inference of scienter.” *Zucco Partners, LLC v. Digimarc Corp.*, 2009 WL 57081 (9th Cir. 2009).

SEC FILINGS AND SETTLEMENTS

Filings

- ❖ The SEC filed charges of fraud against **BarrierMed, Inc.**, **BarrierMed Glove Co.** (Companies), and Victor J. Ragucci, former CEO and president. The complaint alleges that Ragucci and the Companies fraudulently raised millions of dollars by selling unregistered securities through a series of private offerings. The SEC is seeking penalties and an officer and director bar against Ragucci.

Settlements

- ❖ The SEC settled charges of insider trading against Kevin J. Heron, former GC of **Amkor Technology, Inc.** Heron was ordered to pay disgorgement of \$75,000, and was permanently barred from acting as an officer or director of a public company.
- ❖ The SEC settled charges of fraud against Stephan Huse, former head of corporate planning and controlling of **Centerplus Ltd.** Huse was ordered to pay disgorgement of \$14,216, prejudgment interest of \$5,868, a penalty of \$30,000, and was barred from acting as an officer or director of a public company for five years.

SETTLEMENTS (CONT.)

- ❖ The SEC settled charges of fraud against **University Lab Technologies, Inc.** and George Theodoropoulos a/k/a George Theodore, former CEO. Theodore was ordered to pay disgorgement of \$422,578, prejudgment interest of \$36,408, a penalty of \$60,000, and was barred from serving as an officer or director of a public company for ten years.
- ❖ The SEC settled charges of operating a prime bank fraud against Milton J. Vaughn, the estate of Frank R. Johnson and **Asset Recovery and Management Trust (Armtrust)**. Amtrust was ordered to pay disgorgement of \$1,210,000, prejudgment interest of \$960,151, and a penalty of \$300,000. Vaughn was ordered to pay disgorgement of \$1,210,000, prejudgment interest of \$960,151 and a penalty of \$1,210,000. The Estate of Frank R. Johnson was held liable for disgorgement of \$900,000 and prejudgment interest of \$657,786.
- ❖ The SEC settled charges of accounting fraud against James N. Stanard, former CEO of **RenaissanceRe Holdings, Ltd.** Stanard was ordered to pay a penalty of \$100,000.
- ❖ The SEC settled charges of fraud against Kevin Morano, former CFO of **Lumenis, Ltd.** Morano was ordered to pay a penalty of \$55,000.

SHAREHOLDER CLASS ACTION FILINGS AND SETTLEMENTS

Filings

American International Group, Inc. [Medium-Term Notes Series AIG-FP]	Insurance
IBSG International, Inc.	Technology
Metaldyne Corp.	Other
PFF Bancorp	Financial
Rackable Systems, Inc.	Computer [Hardware]
Satym Computer Services, Ltd.	Business Services
Royal Bank of Scotland Group, PLC [Preferred Shares Series T] [IPO]	Banking
Royal Bank of Scotland Group, PLC [Preferred Shares Series Q & T] [IPO]	Banking
The Royal Bank of Scotland Group	Banking
Triad Guaranty, Inc.	Insurance
UBS AG	Banking
Wachovia Corp. [IPO]	Banking
Auction Rate Securities	
Amegy Bank, N.A.	Banking
Mortgage Certificates	
Deutsche Alt-A Securities, Inc.	Financial
Wells Fargo	Banking
Washington Mutual Bank [Series 2006-AR1 Trust]	Financial
Madoff Related	
Beacon Associates, LLC	Financial
Fairfield Sentry	Financial
Herald Funds	Financial
Optimal Strategic US Equity Fund	Financial
Rye Select Broad Market Fund	Financial

Settlements

Bigband Networks, Inc.	Other	\$1,500,000
Candela Corp.	Health Services	\$3,850,000
eMedSoft.com	Other	\$400,000
Himax Technologies, Inc.	Technology	\$1,200,000
Impax Laboratories, Inc.	Pharmaceutical	\$9,000,000
Lancer Partners, L.P.	Financial	\$18,500,000
Lernout & Hauspie Speech Products	Technology	\$3,950,000
LJ International, Inc.	Other	\$2,000,000
Merrill Lynch & Co., Inc. [Includes ERISA & Derivative]	Financial	\$550,000,000
Northwest Biotherapeutics, Inc.	Pharmaceutical	\$1,000,000

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