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803 Corporate and Securities Litigation Update

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Faculty Biographies

Terrence J. Fleming

Terrence Fleming, a partner at Lindquist & Vennum in Minneapolis, Minnesota, maintains a national practice representing parties in cases involving commercial fraud, including shareholder derivative and shareholder class actions, merger and acquisition litigation, regulatory proceedings, investor-broker and law firm disputes, minority shareholder disputes, and securities arbitrations. Mr. Fleming represents parties in regulatory proceedings involving insider trading, securities fraud, accounting issues, and investor complaints before the SEC, FINRA, and state regulatory entities. He has represented parties in more than 100 completed jury and court trials, arbitrations, and regulatory proceedings around the country.

Mr. Fleming is a fellow in the American College of Trial Lawyers. He is a frequent lecturer and also works as an arbitrator, mediator, and expert witness in these areas. He is also an adjunct professor at William Mitchell College of Law, Hamline Law School, and the University of St. Thomas Law School, where he teaches courses on securities regulation and professional ethics.

Mr. Fleming earned his JD from Harvard Law School and his undergraduate degree from the College of St. Thomas.

Steve T. Gannon

Steve T. Gannon is executive vice president and deputy general counsel of Capital One Financial Corporation. Mr. Gannon manages the company's legal department and policy affairs group, which provides a broad range of legal, governance, and public policy advice to Capital One.

Before Capitol One, Mr. Gannon was general counsel of the retail brokerage group of First Union Securities, Inc., now Wachovia Securities, LLC, the nation's second largest retail broker dealer. Mr. Gannon built and managed the firm's legal department, which handled all aspects of the provision of legal advice and services to the retail brokerage firm, its managers and its field personnel. Previously, Mr. Gannon worked at the Richmond firm of LeClair Ryan, PC. Prior to LeClair Ryan, Mr. Gannon practiced in the litigation section of the Hunton and Williams law firm in Richmond, Virginia after serving on the staff of the US Securities and Exchange Commission in Washington, DC.

Mr. Gannon has spoken and written frequently on securities matters and has served on numerous bar committees and community boards, including service as president of the John Marshall Inn of Court. Mr. Gannon also serves on the executive committee of the compliance and legal division of the Securities Industry Financial Markets Association (SIFMA), and is one of Capital One's representatives to the Financial Services Roundtable.

He received his undergraduate degree, cum laude, from Georgetown University, and his law degree from Georgetown University Law Center, where he was an associate editor of the law journal, *The Tax Lawyer*.

Daniel L. Jablonsky

Daniel L. Jablonsky is senior corporate counsel at Flextronics International Ltd., a Singapore registered and NASDAQ listed company, and is responsible for corporate/securities and M&A. Flextronics is a leading electronics manufacturing services (EMS) provider that delivers design, engineering, manufacturing, and logistics services to automotive, computing, consumer digital, industrial, infrastructure, medical, and mobile OEMs.

Prior to joining Flextronics, Mr. Jablonsky was in-house counsel with the legal and compliance group at UBS Financial Services Inc. Before that, he served at the US Securities & Exchange Commission, Division of Enforcement. Mr. Jablonsky began his legal career as a corporate, M&A, and securities attorney with O'Melveny & Myers in Southern California.

Mr. Jablonsky is also an adjunct professor at the Denver University School of Law.

He received his BS from the US Naval Academy, and served as a surface warfare officer and nuclear engineer in the US Navy. He received his JD from the University of Washington School of Law.

SUBPRIME AND CREDIT LITIGATION

A. Origins of the Subprime and Credit Crisis[1]

Subprime loans are loans extended to borrowers with credit scores below 620. The market for these loans grew out Congress's enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA). DIDMCA was enacted to preempt state usury ceilings because those ceilings had prevented many borrowers from obtaining loans. Once these ceilings were removed, subprime lending became increasingly common, especially as subprime mortgage loans became securitized through mortgage-backed securities. Subprime loans now make up approximately 13.1% of outstanding mortgage indebtedness in the U.S. Characteristic of these loans are adjustable interest rates, and many adjustable rate mortgages (ARMs) – representing trillions of dollars – began to reset in 2007 and 2008. As these interest rates reset, and in light of declining home value appreciation, borrowers continue to default. As a result, the value of mortgage-backed securities have plummeted, affecting a wide range of investors including hedge funds, pension funds, municipalities, and investment banks.

B. Suits Against Originators

Initial lawsuits filed against originators were filed by borrowers alleging improper lending practices and shareholders and the SEC alleging false financial statements and disclosure violations. However, other suits against the originators have arisen initiated by issuers who have purchased bundles of subprime mortgages and trustees alleging claims of misrepresentation and breach of warranty based on the mortgage purchase agreements.

Additionally, Originators have faced suits brought by state agencies, such as the action by the New York Attorney General against WaMu, and suits by municipalities bringing claims in the name of public interest. For instance, city of Cleveland has sued 21 banks under state public nuisance law and the city of Baltimore has sued Wells Fargo for violating fair-housing laws by allegedly engaging in "reverse redlining."[2]

[1] Information for this section was gathered from: Kenneth C. Johnston, James B. Greer, Julie K. Biermacher & Joseph Hummel, *The Subprime Morass: Past, Present, and Future*, 12 N.C. BANKING INST. 125 (2008).

[2] *See* Christopher Maag, *Cleveland Sues 21 Lenders Over Subprime Mortgages* N.Y. TIMES, Jan 12, 2008.

C. Other Parties Exposed to Liability

As a result of increased number of suits, originators have sought to shift liability onto other players. Originators may allege breach of contract claims against the brokers, title insurers, closing agents, and appraisers who played a part in early on in the origination process. Originators may allege fraud and misrepresentation as well.

D. Regulatory and Criminal Investigations

The SEC, DOJ, and FBI have all taken an increased interest in investigating the activities of entities all along the subprime marketplace "food chain" from origination through securitization.[3]

However, state attorney generals have proved to be the most prominent players in the auction-rate securites area. The Massachusetts Attorney General's Office reached settlements with J.P. Morgan Chase, Morgan Stanley, Merrill Lynch, UBS, and Wachovia to buy back more than $40 billion of ARS from their clients. And on August 22, 2008, the New York Attorney General's Office announced that it had entered into settlements with three more securities firms to buy back billions of dollars of auction rate securities from retail investors, small businesses and charities. In addition, Merrill Lynch will pay a $125 million penalty, Goldman Sachs will pay a $22.5 million penalty, and Deutsche Bank will pay a $15 million penalty. The New York Attorney General's Office had earlier reached settlements with Wachovia ($8.5 billion) and J.P. Morgan chase and Morgan Stanley ($7 billion) to buy back auction rate securities.

D. Defenses

Lack of scienter
Truth on the market
Loss of causation

II. REGULATORY AND CIVIL ACTIONS AGAINST GENERAL COUNSEL

A. Backdating Stock Options

Fifteen general counsel have been forced out of their positions because of backdating stock options. As recently as May of 2008, the SEC charged general counsel for Broadcom Corp., David Dull, in

[3] *Subprime-Related Securities Litigation: Where Do We Go From Here?* The Subprime Working Group of Gibson, Dunn & Crutcher LLP. (2008).

connection with backdating. Notably, the SEC brought charges against Dull even though an internal investigation exonerated him. General counsel are charged both for being involved in the creation and implementation of stock option programs and for benefiting personally from backdating. In its complaint against Dull, the SEC alleged that Dull profited in the amount of $1.8 million after exercising backdated options. There is no prior genre of cases where general counsel has played such an important role in the wrongdoing. In some cases, they may merely be "taking the fall" for superiors, but in many cases they are responsible because they implemented or approved the arrangements.

Most recently, on August 14, 2008, the SEC announced that Nancy Heinen, Apple's former general counsel, had agreed to pay $2.2 million in settlement, plus $400,000 in interest and a $200,000 civil penalty for her role in the Apple option backdating case. She also agreed to be barred from serving as an officer or director of a public company for 5 years.

B. Electronic Discovery

The Federal Rules of Civil Procedure were amended in 2006 to make electronically stored information (ESI) discoverable and require that ESI be preserved and produced just like paper documents. Attorneys have the duty to locate, review and produce all ESI and take steps to ensure that no potentially relevant data is destroyed. The newest weapon used by counsel is claiming spoliation, so it is vital to have in place a comprehensive document and ESI retention/destruction policy which includes a plan for suspension of the destruction of documents when litigation is pending or anticipated (a "litigation hold").

C. McNulty Memorandum

In light of the growing concern about investigative abuses by the Department of Justice culminating in the finding of constitutional breaches in *United States v. Stein*, U.S. Deputy Attorney General Paul McNulty issued revised guidelines for prosecutors. These guidelines address demands for blanket waivers of attorney-client privilege, the making of such waivers a prerequisite for cooperation, and the pressuring of corporations to withhold legal fees which were traditionally provided to employees and executives in criminal investigations.

The memorandum seeks to clarify that waiver of attorney-client privilege and work-product is not a prerequisite to a finding of cooperation in a government investigation. The memo further provides that requests for waivers are only authorized where there is "a legitimate need" for the privileged information and that requests for

waivers are subject to approval by a United States Attorney upon consultation with the Assistant Attorney General of the Criminal Division. Refusal to grant access to certain non-factual work-product and attorney-client communication, according to the memo, may not be considered for purposes of determining that a company has cooperated with investigation, but refusal to grant access to purely factual information which is related to the underlying misconduct may be considered. With regard to the advancement of fees, the memo instructs that generally this should not be a factor weighed in investigations but that it may be considered in rare cases where it can be shown that the fees were advanced with intent to impede the investigation. It is yet to be seen how prosecutors will implement these guidelines

III. DEVELOPMENTS IN DERIVATIVE LITIGATION

A. *In re UnitedHealth Group Inc. S'holder Derivative Litig.*, No. 06-CV-1216, 2007 WL 4571127

Plaintiffs brought a derivative action alleging that officers and directors received backdated stock options. UnitedHealth Group's board of directors appointed a Special Litigation Committee ("SLC") to investigate the claims. The SLC, which was made up of two retired Minnesota Supreme Court justices, former Chief Justice Kathleen A. Blatz and former Justice Edward C. Stringer, proposed a settlement valued at approximately $922 million. In response, the shareholder derivative plaintiffs requested that the court release stock options and other property in excess of the settlement to the defendant Chairman and CEO, William McGuire. CalPERS, however, opposed the release on the ground that allowing it would jeopardize CalPERS's ability to collect judgment should it prevail in its federal securities class action against UnitedHealth Group pursuant to the PSLRA.

The district court found the balance of factors weighed against releasing the property but was unsure about whether it was authorized to question the findings of the SLC. The Minnesota Court of Appeals has adopted the *Auerbach* rule, which disallows judicial inquiry into the merits of an SLC's decision. *See, e.g., Drilling v. Berman*, 589 N.W.2d 503, 508 (Minn. Ct. App. 1999). Under the rule adopted by the court of appeals, a court may only inquire as to whether the committee was independent and conducted its investigation in good faith. *Id*. While implicitly recognizing the application of the *Auerbach* rule in *Janssen v. Best & Flanagan*, 662 N.W.2d 876, 888 n.5 (Minn. 2003), the Minnesota Supreme Court has not explicitly adopted it. The district court certified to the Minnesota Supreme Court the question of whether it is foreclosed from examining the determination of an SLC on the merits.

The Minnesota Supreme Court answered the certified question with a resounding "no" – the federal court may not review the reasonableness or merits of the independent committee's settlement. In *In re UnitedHealth Group Inc. S'holder Derivative Litig.* File No. A08-114 (Minn. Aug. 14, 2008), the Court determined that the Minnesota business judgment rule requires a court to defer to a special litigation committee's decision to settle a derivate lawsuit if the members of the committee possessed "a disinterested independence" and the committee's process was "adequate, appropriate and pursued in good faith."

B. Standing of Shareholders and Creditors

The continuous ownership rule requires a plaintiff in a shareholder's derivative suit to maintain continuous stock ownership throughout the litigation to preserve his or her standing. A minority of jurisdictions, like Indiana and North Carolina, however, allow shareholders who have been involuntarily disenfranchised to bring a derivative suit where to do otherwise would result in unjust enrichment.

The California Supreme Court in *Grosset v. Wenaas*, 175 P.3d 1184 (Cal. 2008), recently joined the majority of jurisdictions in holding that a former shareholder lacks standing to bring a derivative action, even if the shareholder is disenfranchised during the action by a merger to which he or she did not consent.

Courts have been more accepting of derivative claims by creditors of insolvent companies. In *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007), the Delaware Supreme Court recognized standing for such creditors stating, "When a corporation is insolvent … its creditors take the place of the shareholders as the residual beneficiaries of any increase in value. . . . The corporation's insolvency 'makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value'."

IV. RECENT U.S. SUPREME COURT CASES

A. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S.Ct. 2499 (2007).

Plaintiffs alleged that executives of Tellabs, Inc. violated the PSLRA by misrepresenting their perception of the demand for the Tellab's products. The Seventh Circuit, in analyzing whether the plaintiffs satisfied the heightened pleading standard of the PSLRA held that a complaint defeats a motion to dismiss if "it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." The Supreme Court rejected this formulation holding that "an inference of scienter must be more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent."

<u>Eighth Circuit Interpretations of *Tellabs*</u>:

While courts in other Circuits have held that *Tellabs* imposes a more or less stringent standard for plaintiffs than did their prior precedent, see, e.g. *In re Bisys. Sec. Litig.*, 496 F.Supp. 2d 384 (S.D.N.Y. 2007) (finding it creates a more stringent standard); *ACA Fin. Guar. Corp. v. Advest, Inc.*, 512 F.3d 46 (1st Cir. 2008) (holding it creates a less stringent standard), courts in the Eighth Circuit have interpreted the *Tellabs* standard as consistent with prior precedent. In *Cornelia I. Crowell GST Trust v. Possis Med., Inc.*, 519 F.3d 778 (8th Cir. Mar. 21, 2008), the court cites to *Tellabs* for the proposition that the court must look to "whether *all* the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any allegation, scrutinized in isolation meets that standard." However, it analyzes the pleadings relying on prior precedent.

In *Elam v. Neidorff*, 502 F. Supp. 2d 988 (E.D. Mo. 2007), the district court states, "I do not believe that the *Tellabs* decision is much different from the Eighth Circuit law that existed before. The vast majority of the Eighth Circuit decisions might just as well have been decided under the 'at least as compelling' standard . . . ."

B. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 128 S.Ct. 761 (2008).

Defendants, suppliers of Charter Communications, Inc. ("Charter"), allegedly facilitated Charter in its reporting of inflated operating revenues and cash flow by entering into a series of "wash" transactions with the corporation. A Circuit split existed over the question of whether the private right of action of § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 provides redress against parties, like the suppliers, who participate in a scheme to violate 10b but do not make public misstatements or violate a duty to disclose.

The Supreme Court held that because § 10(b) does not provide a private cause of action for aiding and abetting, defendant's conduct must satisfy each of the elements for liability. The Court found that the plaintiffs could not show reliance on the defendants' representations. In response to the plaintiffs' argument that savvy investors rely not only upon public statements but also upon the underlying transactions reflected in those statements, the Court held that the suppliers' conduct was too remote, stating that to adopt such a definition of reliance under § 10(b) would mean the cause of action "would reach the whole marketplace in which the issuing company does business."

Lower Courts' Interpretations of *Stoneridge*

The District Court for the Southern District of New York in *TCS Capital Mgmt., LLC v. Apax Patners. L.P.*, No. 06-CV-13447 (CM), 2008 WL 650385 (S.D.N.Y. 2008), held that no claim could be made against Telecom Italia for market manipulation. Plaintiffs alleged that Telecom Italia sold shares to other shareholders at an artificially deflated price in return for royalty payments. The court stated that "scheme liability cannot be coupled with efficient market theory to provide grounds for asserting claims against secondary actors whose alleged deceptive conduct was not relied upon by investors."

The Seventh Circuit, in *Pugh v. Tribune Co*., 521 F.3d 686 (7th Cir. 2008), held that overstatement of circulation figures by newspaper-subsidiary's employees was not sufficiently proximate to hold employees liable for investors' harm.

V. LITIGATION TRENDS

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