

Legal Updates & News

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Securities Litigation, Enforcement, and White-Collar Criminal Defense Quarterly Newsletter, Winter 2008

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In This Issue

Our first edition of the Securities Litigation, Enforcement, and White-Collar Criminal Defense (“SLEW”) Quarterly Newsletter begins with a report on our trial win in California in [In re JDS Uniphase Corporation Securities Litigation](#), a class action in which the plaintiffs sought \$20 billion in damages. Next, we discuss [the acquittal of our client in a criminal matter in Massachusetts](#), and lessons for similar cases. We then assess [what the SEC will be focusing on in 2008](#), and review privilege issues to keep in mind when responding to government inquiries. We follow with a discussion of [major Supreme Court holdings in securities litigation](#), including the decision just a few weeks ago in *Stoneridge*. We then turn to China and describe [our work for China-based companies](#) and the unique resources we can bring to bear in such cases. We close with a [report on our recovery, as a court-appointed receiver, of over \\$174 million for bilked investors](#).

JDSU Trial Victory: Jury Finds in Favor of Defendants Across the Board

By [Timothy Blakely](#)

Conventional wisdom holds that when push comes to shove, defendants in a securities class action will not risk trial. This is especially true if the case involves: (1) billions of dollars in shareholder losses; (2) hundreds of millions of dollars of stock sales by directors and officers; (3) complicated accounting issues; (4) a restatement; (5) a pension fund plaintiff; and (6) bet-the-company damages. The deck is supposedly so stacked against defendants that these cases cannot be won, and no company will risk trying. Not so fast.

A Morrison & Foerster team led by Jim Bennett, Jordan Eth, and Terri Garland recently went to trial in a case that combined every one of those ingredients — and won across the board.

The case, *In re JDS Uniphase Corporation Securities Litigation*, arose out of the telecom meltdown of 2001. During that industry collapse, JDSU—a fiberoptic telecommunications components provider—saw its stock price fall from more than \$140/share in the spring of 2000 to less than \$10/share by mid-2001, a market cap loss of approximately \$90 billion. In the wake of the telecom industry’s collapse, JDSU wrote down its goodwill by \$40 billion (the largest write-down of goodwill to that date) and its inventory by more than \$270 million. Predictably, a lawsuit soon followed.

The Lead Plaintiff, the State of Connecticut Retirement Plans and Trust Funds, alleged that four former JDSU executives saw the downturn coming months before it arrived and misled investors about demand for JDSU products while selling JDSU stock worth more than \$500 million. The Lead Plaintiff also alleged that JDSU “cooked its books” by overstating its goodwill and inventory, and that JDSU filed misleading registration statements in connection with significant mergers. The Lead Plaintiff claimed \$20 billion in damages under a

number of federal securities laws, including Sections 11 and 12 of the Securities Act, and Sections 10(b), 14, and 20A of the Securities Exchange Act.

Morrison & Foerster, which represented JDSU and three of the former executives, successfully narrowed the case through discovery and motion practice, and the case went to trial in Oakland, California, in October 2007. After a four-week trial, and testimony from more than 40 witnesses (including eight experts), a nine-person Oakland jury returned a complete defense verdict after two days of deliberations.

What does this result teach companies and executives faced with similar claims? There are many lessons learned, but three stand out:

First, raw populism does not necessarily dictate outcomes. Jurors take their responsibilities seriously. They will be convinced by facts, not name calling, and it is not enough for plaintiffs to allege that “greedy” executives “dumped” their stock on an unwitting public. Jurors will also pay close attention to the individual defendants themselves, rather than caricatures based on their wealth.

Second, to preserve trial as a winnable option, defendants faced with securities claims should begin planning early so that: (1) long-term positions are not compromised for tactical gains; and (2) affirmative evidence is preserved and pursued so that it can be presented at trial. Even though settlement is still by far the most likely outcome of a securities fraud class action, effective preparation for trial can allow defendants to negotiate from a position of strength.

Third, what sometimes seems like unimportant pretrial wrangling can make a huge difference at trial (and in negotiating a settlement). The deposition of a third party; the motion to compel that pins down an evasive answer; the request for admission that eliminates a claim; the interview of an alleged “confidential witness”—all these activities contribute to shaping the eventual outcome, and all should be undertaken purposefully with that goal in mind.

To be sure, class action securities claims can present great risk to defendants, and not every case can be won at trial. The recent jury verdict for plaintiffs in the Apollo Group securities trial illustrates this point. If the JDSU trial teaches anything, however, it is that companies and individuals accused of securities fraud need not roll over in the face of meritless claims — no matter how aggressively pled or litigated.

Timothy Blakely is an associate in the firm's San Francisco office and was on the JDSU trial team.

Washington, D.C. Criminal Defense Team Wins Acquittal for Client in Case in Which Other Defendants Pled Guilty

By [Adam Hoffinger](#)

In May 2007, a trial team from our Washington, D.C. office, led by Adam Hoffinger, won an acquittal for Melissa Vaughn, a former sales executive of EMD Serono, the U.S. division of Swiss-based life sciences company, MerckSerono. *United States v. John Bruens, Mary Stewart, Melissa Vaughn, and Marc Sirockman*, No. 05-CR-10102 (United States District Court for the District of Massachusetts, Hon. John L. Tauro). The Government accused Ms. Vaughn, and three other executives, of violating the federal Anti-Kickback Statute by offering doctors expense-paid trips to a medical conference in Cannes, France, in return for prescribing the company's anti-AIDS drug, Serostim. The investigation, conducted by the Department of Justice, the Federal Bureau of Investigation, and other agencies, lasted more than three years. Ms. Vaughn faced up to 15 years in prison and a \$750,000 fine.

During the three-week trial, the Government presented testimony from whistleblowers who had reaped substantial monetary rewards, and from individuals who had promises of Government leniency in return for testimony against the four defendants. Three hours after beginning its deliberations (including time for lunch), the jury reached its verdict, acquitting all defendants on all counts.

The speedy verdict, finding that the Government had failed to prove any part of its case against any of the defendants, is particularly significant because the Government had obtained guilty pleas from others for the same conduct from which Ms. Vaughn and the other three defendants were exonerated. Among the guilty pleas was one from the defendants' employer, Serono, which in 2005 pled guilty to the same anti-kickback violations. Serono agreed to pay over \$700 million in fines and penalties. Another Serono sales director likewise pled guilty to kickback charges (after our acquittals, he was sentenced to probation).

The trial was a classic example of how the Government's ability to pressure corporate defendants does not necessarily bode well for the Government's prosecution of individuals. The pressure on companies, especially in regulated industries, to capitulate in Government investigations can be excruciating. The risks of going to trial and losing can be devastating: monumental losses in income and profits, a barrage of negative publicity, never-ending shareholder lawsuits, and sometimes the very existence of the company itself (e.g., Arthur Andersen). The Government can, and often does, take maximum advantage of the company's predicament to secure guilty pleas, massive fines, and cooperation. The Government is then able to compel the company's assistance in locating witnesses, collecting documents, and building cases against individuals.

In its zeal to obtain quick settlements and pleas from the company, however, the Government often fails to scrutinize the evidence against individuals to determine, before indicting, whether it can prove guilt beyond a reasonable doubt at trial. Ms. Vaughn's acquittal demonstrates that the Government's success at pressuring a regulated company into pleading guilty and paying large fines does not necessarily mean a jury will find that law-abiding company executives risked jail and ruin to knowingly and willfully commit crimes. The speed and clarity of the jury's verdict – needing only three hours, including a meal break, to reject a case three years in the making – is a valuable reminder that government power outside the courtroom is no substitute for proof in the courtroom.

Adam Hoffinger is a partner in the firm's Washington, D.C. office.

SEC Enforcement Priorities

By [Randall J. Fons](#) and [Brian Hoffman](#)

While one never knows what surprises 2008 will bring, the SEC Commissioners and staff have enumerated, in speeches and articles, several enforcement priorities for the agency.

First, options backdating. Although faced with a large backlog of potential cases, all signs appear to indicate that the Division of Enforcement is winding these matters down. New investigations appear to be almost non-existent, and many ongoing investigations are being closed without enforcement action. The SEC enforcement staff has made it clear that they intend to focus on a limited number of matters involving particularly troubling facts. Many companies that are not currently the subject of active and aggressive investigations may thus be able to breathe a cautious sigh of relief. But, companies should apply the general internal controls, accounting, and reporting lessons learned vis-à-vis stock options to other areas.

Second, insider trading. In recent months, the SEC has commenced a multitude of investigations, and brought numerous cases, for alleged insider trading. The matters span the spectrum: tippers, tippees, insiders, outsiders, private company employees, external auditors, and regulated entity personnel. And the SEC's public message, that insider trading of any sort will be pursued, is clear. Companies should thus double-check their policies and procedures in this area and, if necessary, take appropriate corrective action.

Third, 10b5-1 plans. Fueled by an academic study (similar to stock options) showing the improbability of certain trading patterns if 10b5-1 plans were properly entered into, the SEC has begun looking very closely at these plans. Such plans provide valuable protections to insiders who wish to trade their company's stock, but who fear insider trading charges. However, 10b5-1 plans must be appropriately established and must sufficiently remove the insider's discretion over the periodic trading. Moreover, an employee's simultaneous cancellation of one plan and initiation of a new plan should be carefully reviewed by companies and their counsel. Although this ground has not often been plowed by the SEC, the staff has made it clear that it is ready to dig in.

Fourth, the Foreign Corrupt Practices Act ("FCPA"). With increasing economic globalization, and particularly unprecedented industrialization in newly developing areas, it comes as no surprise that abuses, namely bribery and other unsavory business practices, have occurred. The SEC, which, along with the Justice Department, is charged with enforcing the FCPA, has recently increased its focus on these matters. Moreover, the financial penalties for violating the FCPA have been increased to include profits resulting from any illegal bribes. Thus, even a small "indiscretion" by an employee or consultant can easily result in financial penalties in the millions of dollars. Companies with international operations should make sure that their strong domestic internal controls extend overseas.

Finally, the SEC will continue to focus on its "bread and butter" matters: financial reporting and disclosure issues. While Sarbanes-Oxley and increased auditor "vigilance" have, at least anecdotally, decreased the incidence of inappropriate financial reporting and disclosures, the SEC enforcement staff will actively pursue

any problems it notes in this area. As a result, companies should continue to maintain strong internal controls and take care with their disclosures.

Randall J. Fons is a partner, and Brian Hoffman is an associate, in the firm's Denver office.

Waiving Privilege with the SEC and the Justice Department

By [Randall J. Fons](#) and [Brian Hoffman](#)

Despite the SEC's support, a proposed codification of a privilege-protection rule known as the selective waiver doctrine has been rejected. The selective waiver doctrine would allow companies to continue to assert, typically against private litigants, the attorney-client communication and work product privileges for materials that had been disclosed to the SEC or Justice Department during an investigation. Lacking such a rule, companies continue to find themselves in the uncomfortable position of operating under the "old" rules, which often results in a privilege waiver.

The SEC vocally endorsed a proposed codification of the selective waiver doctrine in Federal Rule of Evidence 502, which largely deals with privilege waiver in private litigation. The Advisory Committee on Evidence Rules recently rejected that proposal, in part because it runs contrary to a number of judicial decisions. Several courts have rejected the selective waiver doctrine and found that a privilege waiver occurs once a company discloses protected materials to the Government. On a related front, proposed legislation that would limit government agencies' ability to ask for privileged materials faces strong opposition before the Senate Committee on the Judiciary.

Absent the selective waiver doctrine and limitation on the Government's ability to seek privileged materials, companies must operate under policies that the Justice Department and the SEC adopted in the wake of various notorious corporate scandals. These policies permit the agencies to consider a company's privilege waiver when assessing whether a company cooperated in an investigation. Many view these policies as *de facto* requirements to produce privileged materials to the Government. Under the holdings of several courts, production of the materials can result in private litigants gaining access to whatever the company provides to the Government, even if those materials would be otherwise privileged. Although the Justice Department has revised its policies on privilege waivers by adding procedural steps before it may seek a waiver, the SEC has not changed its original policies.

While the battle over the selective waiver doctrine and a limitation on the Government's ability to request privileged materials continues, companies should carefully weigh all the consequences, in both the enforcement and private action arenas, before deciding how to respond to a government investigation.

U.S. Supreme Court Scrutinizes Securities Class Actions in Two Recent Cases

By [Beth S. Brinkmann](#) and [Mark R.S. Foster](#)

The past seven months have brought significant scrutiny by the United States Supreme Court of securities class actions. In two prominent cases, *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, No. 06-43, 552 U.S. ___, 2008 WL 123801 (January 15, 2008) and *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007), the Court confronted Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, the antifraud provisions most frequently invoked by private plaintiffs in securities class actions. In both instances, the Court ruled in favor of the defendants and specifically voiced concern about potential abuses of unchecked Section 10(b) securities fraud claims by private plaintiffs. A critical feature in both cases was the Private Securities Litigation Reform Act of 1995 ("PSLRA"), which Congress enacted to curb abusive securities class actions. The Court construed the PSLRA in each case to limit the scope of the private right of action under Section 10(b).

The Supreme Court's current interest in securities class actions bears watching. The number of cases heard by the Supreme Court has been decreasing in recent years, but the Court has expressed greater interest in certain issues that significantly affect business interests and the Court has often issued broad rulings that favor such interests. *Stoneridge* and *Tellabs* are illustrative of a recent trend where the Court has issued pro-business decisions. In 2005, the Supreme Court decided *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), which required private plaintiffs to meet an elevated standard for pleading loss causation (i.e., proximate cause) in Section 10(b) actions. In 2006, the Supreme Court decided *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006), which ruled for defendants in holding that private plaintiffs cannot

file class actions in state court to circumvent the heightened pleading standards and limitations on private actions that Congress imposed when enacting the PSLRA in 1995 and the Securities Litigation Uniform Standards Act in 1998.

No Section 10(b) Actions by Private Plaintiffs Against Third Parties

Stoneridge rejected an attempt by plaintiffs to extend Section 10(b) liability to third parties based on a “scheme liability” theory for corporate fraud. The Supreme Court ruled that third parties (e.g., customers, suppliers, and the like) who engage in business transactions with a public company have no Section 10(b) liability to private plaintiffs when the public company, or people who speak on behalf of the public company, misrepresent to investors the nature of those business transactions. This is so even where the third party knows about the public company’s misrepresentation, or where the third party engages in a deceptive scheme or sham transaction with the public company, so long as the third party did not itself issue any public statements to advance the alleged fraud.

The Court explained that a third party’s business transactions with a public company are too far removed from the facts on which the investors rely when they buy and sell stock. A contrary rule would improperly extend liability from conduct connected to the securities markets and the financing of companies “into the realm of ordinary business operations,” which is beyond the scope of Section 10(b).

The Court’s protection of third parties from private plaintiffs turned, in large part, on Congressional intent. The Court explained that when Congress enacted the PSLRA, Congress expressly gave the SEC the authority to enforce Section 10(b) against third parties, but it did not act upon recommendations that it give private plaintiffs that same power. The Court would not contravene Congress’s determination that “this class of defendants should be pursued by the SEC and not by private litigants.” The Court further noted the risk that “plaintiffs with weak claims” could use the threat of massive discovery and other litigation costs “to extort settlements from innocent companies,” a threat that could adversely affect the country’s capital markets.

Stoneridge rejected a contrary standard that had been endorsed by the United States Court of Appeals for the Ninth Circuit in *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040 (9th Cir. 2006). One week after deciding *Stoneridge*, the Supreme Court summarily vacated and remanded the *Simpson* decision for further consideration in light of *Stoneridge*. The Court simultaneously refused to review an order denying class certification of “scheme” claims asserted in litigation arising out of the collapse of Enron.

A Heightened Pleading Standard for Plaintiffs to Allege Scierter

Defendants in securities class actions also benefited from the Supreme Court’s decision in *Tellabs*. In the PSLRA, Congress imposed an “exacting” pleading standard that requires private plaintiffs to plead detailed facts that give rise to a “strong inference” that a defendant acted with scierter. Congress did not define what it meant by a “strong inference,” and the lower courts ultimately adopted conflicting interpretations of the standard when ruling on all-important motions to dismiss.

Tellabs resolved the split of authority by establishing a uniform definition of “strong inference.” The Court held that a “strong inference” is one that is “more than merely plausible or reasonable — it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.”

By requiring inferences of scierter to be as strong as opposing inferences, the Court thereby required that trial courts consider competing inferences, including inferences of innocence that favor defendants, to determine whether a private securities action alleges facts sufficient to establish scierter. Before *Tellabs*, some lower courts considered inferences favorable to defendants, but many would not. *Tellabs* thus ensures that, early in litigation, defendants are able to argue that there are alternative explanations for alleged misconduct that are more cogent than the inferences urged by a plaintiff.

Although *Tellabs* sets a high bar for plaintiffs, the bar is not insurmountable. The Court’s standard was geared towards Congress’s twin goals under the PSLRA: “to curb frivolous, lawyer-driven litigation, while preserving investors’ ability to recover on meritorious claims.”

To date, defendants have fared well overall under the *Tellabs* standard. There have been eight decisions from six Courts of Appeals applying *Tellabs*, with all but one affirming dismissals for defendants. The results at the trial court level have been more mixed for defendants as judges attempt to weigh competing inferences. Time will tell whether the *Tellabs* standard achieves uniform application of the “strong inference” standard or whether lower courts will need further guidance on how to weigh competing inferences.

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Leading the Defense of China-Based Companies in U.S. Securities Litigation

By [Jack Auspitz](#)

Among the ramifications of China's emerging role on the world economic stage is an increase in securities class actions against China-based companies that list their securities on U.S. markets. Morrison & Foerster is the leading firm in representing Chinese companies in U.S. securities litigation. We are representing the defendants in two such actions and have been involved in other such cases, including successfully representing China's largest investment banking firm, China International Capital Corporation (Hong Kong) Limited ("CICC"), in securities litigation in federal court in California, and what was perhaps the first securities class action ever brought against a China-based company, NetEase.

Jack Auspitz, Joel Haims, and Lily Fan from our New York office are representing Qiao Xing Universal Telephone, Inc. in the Southern District of New York and, with Dan Marmalefsky and Saro Balian from our Los Angeles office, are representing LJ International Inc. in the Central District of California. In both cases, Plaintiffs have tried to exploit changes in accountants or other events – occurrences that non-U.S.-based companies might not recognize as posing a risk of a stock drop and resulting litigation.

SLEW attorneys defend China-based companies in litigation and, with Morrison & Foerster attorneys in Hong Kong, Shanghai, and Beijing, educate China-based companies about the risk of securities litigation and the steps that can be taken long in advance to avoid or minimize the risk of litigation. Given the continued activity by China-based companies in U.S. markets, and the increasing turmoil in those markets, the SLEW Practice Group expects to see more class actions against China-based companies. The success of China-based companies in avoiding or defeating such litigation in 2008, particularly in a challenging economic environment, could have long-term effects on how other China-based companies attempt to avoid or minimize the risk of litigation, and on how plaintiffs' firms view the prospects of suing China-based companies.

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Chip Loewenson, as Court-Appointed Receiver, Recovers Over \$174 Million for Fraud Victims

By [Michael Gifford](#)

From 1996 to 1999, almost 200 customers contributed approximately \$200 million to Credit Bancorp, Ltd. ("CBL"), only to learn later that they had "invested" in a Ponzi scheme. Serving as a court-appointed receiver, New York partner Carl H. Loewenson, Jr., has led an eight year effort that has resulted in the recovery of over \$174 million for these customers.

In November 1999, the Securities and Exchange Commission ("SEC") filed *SEC v. Credit Bancorp, Ltd.* in the Southern District of New York, seeking emergency relief against CBL, its mastermind Richard Blech, and others. In January 2000, the Court appointed Mr. Loewenson as receiver in this action.

Working with the United States Department of Justice, the SEC, and their respective foreign counterparts, Mr. Loewenson has led a team of Morrison & Foerster attorneys, and local counsel in other countries, in finding and recovering assets around the world. Now in its eighth year of operation, the receivership has identified and recovered assets situated in Great Britain, Monaco, France, Switzerland, and the United States, returning more than \$174 million to the victims of the CBL fraud. These assets include bank accounts in various countries, securities traded on a variety of exchanges, investments in technology startup companies and hedge funds, homes in Europe and the United States, a rare bird aviary, a hotel on the French Riviera, yachts moored in Monaco and Switzerland, jewelry, and a vast wine collection.

In the course of their work, Mr. Loewenson and his team have litigated in courts in New York, California, the United States Court of Appeals for the Second Circuit, and in France, including France's Supreme Court. Mr. Loewenson and his team continue to pursue CBL assets around the world.

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