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SECTION OFFICERS and COUNCIL MEMBERS

COVER: "Death Valley, California," photograph by Larry Gustafson, Dallas.

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FROM THE SECTION CHAIR

Dear Section Members:

This issue marks the beginning of my term as Section Chair. I am honored to serve and look forward to working with you and our Section Council during the coming year.

I would like to take this opportunity to welcome the four incoming members of the Council. James Berglund, Barry Golden, Brian Robinson and Anne Rogers will serve terms running from 2008 to 2011.

The *Journal* continues to provide Section members with valuable news and scholarship covering a wide variety of topics of interest to business litigators. Thanks to Gerry Pecht and Peter Stokes for their annual survey of securities law developments, to Randy Gordon and Sam Joyner for their annual survey of RICO developments, and to Alex Fernandez and Andy Yung for their timely article on stock options backdating. As always, thanks also to Larry Gustafson for his cover photograph. If you have an article in mind, please contact Mike Ferrill (amferrill@coxsmith.com) – we're always on the lookout for interesting articles touching on any aspect of business litigation.

In closing, I would like to thank Randy Gordon for his terrific leadership during the past year. He did an outstanding job, and together with the Section's Council I look forward to building on his fine work.

Best regards,
Bill Katz
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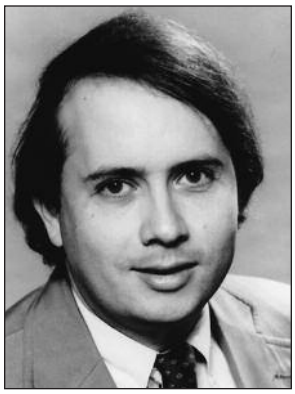
FROM ▪ THE ▪ EDITOR



This issue of the Journal features the annual survey articles on securities law and RICO developments, and an article on stock options backdating.

As always, we solicit written contributions to the Journal. We currently have commitments for annual survey articles on antitrust, securities, RICO, business torts, arbitration, class actions, D&O and expert witness developments. If you have an idea for a survey article in another area of business litigation, or an article focusing on a particular aspect of or development in the law (even if it falls within one of the broad survey categories), contact me at 112 E. Pecan, Suite 1800, San Antonio, Texas 78205 (210) 554-5282; (210) 226-8395 (fax), amferril@coxsmith.com.

A. Michael Ferrill
Editor

Fifth Circuit Securities Update

By Gerard G. Pecht and Peter A. Stokes[1]

Gerard G. Pecht

Peter A. Stokes

Since the last survey period, the Fifth Circuit has addressed several important securities-related issues, including: (1) the proper application of the Supreme Court's scienter standard as set forth last year in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*;[2] (2) the requirements for asserting "whistleblower" claims under section 806 of the Sarbanes-Oxley Act; (3) the contours of the diversification and prudence requirements in an ERISA class action involving a company retirement plan's investment in the company's own securities; (4) the effect of a brokerage firm's lapsed National Association of Securities Dealers ("NASD") membership on its right to compel arbitration; (5) the tax treatment of an investor's obligation to close a short sale; (6) the availability of a private right of action for money damages under section 13(d) of the Securities Exchange Act (the "Exchange Act"); (7) the requirement to prove loss causation at the class certification stage in a Rule 10b-5 class action; (8) several issues from the ongoing Enron civil and criminal matters, including the effect of collateral estoppel on the government's efforts to re-indict certain Enron Broadband executives following their acquittal on certain charges and the preemptive reach of the Securities Litigation Uniform Standards Act ("SLUSA") on a series of state court class action cases that were consolidated with the federal Enron securities litigation; (9) the obligations of securities plaintiffs and objectors who want to avoid having their claims released in a classwide settlement; (10) what constitutes "inquiry notice" sufficient to trigger the federal statute of limitations on Rule 10b-5 and Securities Act misrepresentation claims; and (11) the ability of a Maryland real estate investment trust's board to take defensive measures against a former CEO's takeover attempt.

In *Indiana Electrical Workers' Pension Trust Fund IBEW v. Shaw Group Inc.*,[3] the Fifth Circuit reversed a district court's denial of a motion to dismiss in a Rule 10b-5 class action case and held that the complaint did not adequately allege scienter under *Tellabs* and the Private Securities Litigation Reform Act ("PSLRA"). The plaintiffs in *Indiana Electrical* filed suit in the United States District Court for the Eastern District of Louisiana after Shaw announced that the SEC had begun an informal inquiry into its accounting practices.[4] The SEC ultimately terminated its inquiry with no enforcement recommendation, and the company was never required to restate its earnings.[5] The plaintiffs nonetheless alleged that Shaw artificially inflated its financial statements by supposedly: (i) manipulating the purchase method of accounting in connection with certain acquisitions; (ii) prematurely recognizing revenue on certain contracts; (iii) failing to disclose material issues regarding a major construction project; (iv) overstating its backlog of contracts; and (v) delaying payments to vendors. The district court denied Shaw's motion to dismiss with no written opinion.[6]

The Fifth Circuit granted interlocutory review – a rare step at the dismissal stage – and remanded with instructions to grant Shaw's motion.[7] The court began by noting that Tellabs affirmed a three-step approach to reviewing scienter allegations on a motion to dismiss. First, the court must accept the plaintiffs' factual allegations as true. Second, the court must evaluate all allegations in the complaint collectively and may consider documents incorporated into the complaint by reference and matters subject to judicial notice. Third, the court must take into account plausible opposing inferences in determining whether the complaint as a whole supports a "cogent and compelling" inference of scienter.[8] The Fifth Circuit also reaffirmed its prior holdings that motive and opportunity allegations are insufficient, standing alone, to support a strong inference of scienter, that "group pleading" is impermissible, and that a complaint must establish scienter individually as to the persons responsible for the alleged misstatement and may not plead scienter based on a corporation's alleged "collective knowledge."[9] In addition, the opinion emphasized that a court may not infer scienter from the mere fact that executives had a "hands-on management style," or

even from an executive's alleged boast that "there is nothing in this company that I don't know," as such allegations are insufficiently specific to satisfy the PSLRA.[10]

In holding that the complaint failed to support a "cogent and compelling" inference of scienter, the court made several key rulings that could impact future Rule 10b-5 cases. First, noting that the bulk of the complaint focused on alleged accounting violations, the Fifth Circuit reiterated that a failure to comply with generally accepted accounting principles ("GAAP") is insufficient by itself to support a strong inference of scienter.[11] The opinion also faulted the plaintiffs for failing to allege any specifics regarding the estimated amount of the earnings overstatement or what the "true" numbers should have been.[12] The court observed that asset valuations and the "application of sophisticated accounting standards like 'fair value' . . . leave broad scope for judgment and informed estimation," and that a plaintiff "cannot transform inherently nuanced conclusions into fraudulent misstatements or omissions simply by saying that there were abuses or misuses of the GAAP rules."[13] This language could make it more difficult for plaintiffs to pursue securities fraud claims based on accounting-related judgment calls that turn out to be wrong.

The opinion also criticized the complaint's reliance on unnamed "confidential sources," which is a frequent tactic by plaintiffs in securities litigation. The court observed that "[f]ollowing *Tellabs*, courts must discount allegations from confidential sources," and that "[s]uch sources afford no basis for drawing the plausible competing inferences required by *Tellabs*."[14] It favorably cited the Seventh Circuit's opinion in *Higginbotham v. Baxter International, Inc.*, which held that confidential source allegations must be discounted.[15] The opinion concluded that "[a]t the very least, [confidential] sources must be described 'with sufficient particularity to support the probability that a person in the position occupied by the source . . . would possess the information pleaded . . . .'"[16]

Applying this standard, the Fifth Circuit found the plaintiff's confidential source allegations deficient because they failed to provide sufficient information regarding the alleged witnesses' positions or responsibilities, or regarding the timing, context, and content of the statements they allegedly overheard.[17] For example, while the plaintiffs alleged that a "former Baton Rouge project controls manager" informed a Shaw executive regarding "all of the problems associated" with its project tracking software, they failed to identify "when, how, and what the confidential source told" the executive and failed to provide sufficient information to demonstrate that the alleged source was in a position to know of the alleged problems.[18] The confidential source allegations were thus insufficient to support a strong inference of scienter.[19]

In addition, the Fifth Circuit clarified that an "incomplete disclosure" is not actionable under Rule 10b-5 unless the omitted information renders the defendant's affirmative statements materially misleading.[20] The mere fact that a disclosure is allegedly incomplete, or that a company fails to disclose material information, is thus insufficient in itself to support a federal securities fraud claim.[21]

The decision also emphasized that large stock sales by corporate officers are not probative of scienter unless they occur in "'suspicious amounts or at suspicious times.'"[22] Consistent with *Tellabs*, the court must examine stock sale allegations holistically to determine whether the sales are out of line with prior practices or otherwise raise suspicion; the mere fact that an executive sells large blocks of company stock does not by itself support any inference of scienter.[23] The court concluded that the sale by one Shaw executive of 57% of his company stock immediately after the company made its allegedly inflated earnings announcement did not support an inference of fraud, given that the executive had made similarly large sales before the announcement, and given that the sales came almost immediately after his lock-up period expired.[24] Additionally, the court reiterated its longstanding rule that executive compensation and bonuses are generally insufficient to support a strong inference of scienter.[25]

Finally, the opinion clarified that an executive's certification of a company's financial statements under the Sarbanes-Oxley Act does not support a strong inference of scienter unless there are particularized allegations demonstrating that the executive did so with severe recklessness or intent to defraud.[26] In other words, a plaintiff may not bootstrap a federal securities fraud claim based solely on an executive's certifications of allegedly inaccurate financial statements, but must plead additional specific facts demonstrating that the certifications were made fraudulently or with severe recklessness.[27]

In *Central Laborers' Pension Fund v. Integrated Electrical Services, Inc.*,[28] the Fifth Circuit affirmed dismissal of another Rule 10b-5 class action suit under *Tellabs*. The plaintiffs alleged that Integrated Electrical Services ("IES") misrepresented its financial condition, violated GAAP, and had to restate its financial statements for fiscal years 2002 and 2003 and for the first two quarters of 2004.[29] The effect of the restatement was to reduce IES's net income by 14%, from $42.1 million to $36.5 million, for the period covered by the restatement.[30] The plaintiffs attempted to bolster their allegations of fraud by pointing to stock sales by IES executives, allegations by "confidential witnesses," and Sarbanes-Oxley certifications that the plaintiffs asserted were proven false by the restatement. The Southern District of Texas dismissed the case with prejudice and held that the allegations failed to support a strong inference of scienter.[31]

Relying on *Tellabs* and prior circuit-level caselaw, the Fifth Circuit affirmed the district court's conclusion that scienter was not adequately alleged.[32] The court noted that a district court "'must engage in some weighing of the allegations to determine whether the inferences toward scienter are strong or weak,'" and that it "must examine [the complaint's] allegations *in toto*" in determining whether a strong inference of scienter can be drawn.[33] While the

Fifth Circuit noted that some of the allegations provided a basis for inferring scienter, the collective inference from all of the allegations was not strong enough to satisfy *Tellabs*. For example, the Fifth Circuit noted that the restatement and accounting violations "provide some basis to infer scienter," but that "GAAP violations, without more," will not support the *strong* inference that the PSLRA requires.[34]

The court also found that the "confidential witness" allegations were not sufficiently particularized to support a strong inference of scienter.[35] While one of the alleged sources claimed to have overheard an IES executive stating that he "did not want to know the details of a revenue issue so that he would not be liable," the allegation lacked sufficient corroborating details regarding the source's job responsibilities, employment dates, and the specific context of the alleged remark to raise a strong inference of fraud.

Turning to the stock sale allegations, the Fifth Circuit observed that one of the two defendants who sold stock had sold only 4% of his total holdings, and that his "skeletal" stock sales failed to support an inference of scienter.[36] The other selling defendant, however, exercised 351,335 of 371,116 options and made a profit of $1.44 million.[37] While IES argued that these sales were made pursuant to a divorce decree and a 10b-5-1 plan, the Fifth Circuit found that these arguments did not "counsel a conclusion that [the sales were] non-suspicious," and that the sales thus "contribute to an inference of scienter."[38] Nonetheless, when considering the allegations holistically, the inference was not "cogent and compelling" enough to survive dismissal.[39] Finally, as in *Indiana Electrical*, the Fifth Circuit concluded that the Sarbanes-Oxley certifications failed to support a strong inference of scienter, noting that the plaintiffs did not "clearly explain the link between [the certifications] and the actual accounting and reporting problems that arose."[40]

The court thus concluded that the "collective impact" of the plaintiffs' allegations did not support a strong inference of scienter and affirmed the district court's dismissal.[41] The court also held that the district court did not abuse its discretion by not allowing leave to amend, noting that the additional information that the plaintiffs proposed adding to their complaint would not have cured the deficiencies.[42]

In addition to the published decisions in *Indiana Electrical* and *Central Laborers*, the Fifth Circuit also issued two unpublished opinions addressing Rule 12(b)(6) dismissals of federal Rule 10b-5 complaints. In *Templin v. SourceCorp, Inc.*,[43] the court affirmed the dismissal of a Rule 10b-5 class action filed against SourceCorp, two individual defendants, and another company called Image Entry, Inc. in the Northern District of Texas.[44] The district court had granted dismissal as to SourceCorp and the two individual defendants based on the complaint's failure to plead specific facts demonstrating that the individual defendants knew the company's financial statements were false when made.[45] The district court denied dismissal as to another individual defendant who had sold Image Entry to SourceCorp, but held that the complaint failed to allege sufficient facts to impute his scienter to Image Entry.[46] The Fifth Circuit affirmed the district court's dismissals "essentially for the reasons given by the district court," without further elaboration.[47]

In *Flaherty & Crumrine Preferred Income Fund Inc. v. TXU Corp.*,[48] the Fifth Circuit vacated a dismissal by the Northern District of Texas to allow the plaintiffs an opportunity to replead their federal section 10(b) and 14(e) claims in light of the Supreme Court's *Tellabs* decision, which had come down while the case was on appeal.[49] The case involved allegations of misrepresentations in connection with a self-tender offer by TXU Corp. to purchase certain convertible securities.[50] The remand order did not express any opinion on the merits.[51] On remand, the Northern District again granted dismissal, holding that the amended complaint failed to satisfy *Tellabs*.[52] The case is now back on appeal.

The Fifth Circuit also issued two opinions addressing "whistleblower" claims under section 806 of the Sarbanes-Oxley Act, 18 U.S.C. § 1514A(a). In *Getman v. Administrative Review Board*,[53] the court affirmed the Administrative Review Board's rejection of a former Southwest Securities research analyst's claim that her termination resulted from protected "whistleblowing" activity. The analyst asserted that she was terminated after disagreeing with Southwest Securities' Review Committee about a stock rating and refusing to accept the Committee's rating.[54] After the Occupational Safety and Health Administration ("OSHA") rejected her claim, she requested an administrative law judge ("ALJ") hearing and, when that proved unsuccessful, appealed to the Administrative Review Board ("ARB").[55] The ARB concluded that the analyst's "unexplained refusal to change her recommended rating" was "not protected activity" under section 806.[56]

The Fifth Circuit affirmed the ARB's decision, noting that the analyst admitted during the ALJ hearing: (i) that the Southwest Securities Review Committee did not ask her to upgrade the rating; and (ii) that she never told anyone at Southwest that she thought changing the rating would violate any federal securities laws.[57] Because section 806 only protects employees who "provide information, cause information to be provided, or otherwise assist in an investigation regarding . . . conduct which the employee reasonably believes constitutes a violation of [18 U.S.C.] section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders," the Fifth Circuit concluded that the analyst's conduct did not fall under section 806's protection.[58]

Likewise, in *Allen v. Administrative Review Board*,[59] the Fifth Circuit rejected a section 806 complaint by three former employees of Stewart Enterprises who claimed they were terminated for complaining about various alleged accounting errors and nondisclosures.[60] The court noted that to succeed on a whistleblower claim, the employee must prove by a preponderance of the evidence that: (1) she engaged in protected activity; (2) the employer knew that she engaged in the protected activity; (3) she suffered an

unfavorable personnel action; and (4) the protected activity was a contributing factor in the unfavorable action.[61]

As in *Getman*, the ALJ and ARB rejected the petitioners' claims and found that they did not "definitively and specifically relate" to "protected activity" under section 806, which again is limited to violations of 18 U.S.C. sections 1341, 1343, 1344, or 1348, any rule or regulation of the SEC, or any provision of federal law relating to fraud against shareholders.[62] The ALJ found after a six-day trial that the petitioners did not have an objectively reasonable belief that the employer's conduct violated any such federal statute or regulation.[63] While one of the petitioners had complained that Stewart had violated SEC Staff Account Bulletin ("SAB")-101 in certain of its internal financial statements, the Fifth Circuit observed that an SAB is not a "rule or regulation" of the SEC and, in any event, did not apply to a company's internal financial documents.[64] Because the complainant had an extensive accounting background and knew that the financial documents had not been filed with the SEC, the Fifth Circuit concluded that the ALJ's and ARB's findings were supported by substantial evidence.[65] The court also found that substantial evidence supported the ALJ's and ARB's conclusion that the petitioners' complaints about alleged nondisclosures of various problems with interest calculations, delayed refunds, and the company's billing system did not involve a violation of the federal securities laws, noting that the record contained substantial evidence that the alleged nondisclosures resulted from innocent or negligent programming mistakes and thus could not support an objectively reasonable belief that the company had committed securities fraud.[66] The court emphasized that it was required to give considerable deference to the ALJ and ARB findings and was limited to a "substantial evidence" review.[67]

In *Kirshbaum v. Reliant Energy, Inc.*,[68] the Fifth Circuit affirmed summary judgment in an ERISA class action alleging that Reliant Energy's "Reliant Energy Savings Plan" (the "Plan") violated ERISA's diversification and prudence requirements by investing almost entirely in Reliant's common stock, and by continuing to invest in Reliant stock after the share price fell significantly.[69] The decline occurred after the disclosure that certain Reliant employees had engaged in "round-trip" energy trades between 1999 and 2001.[70] The plaintiffs filed a class action complaint alleging that Reliant and the individuals serving on the Reliant Benefits Committee should have known that investing large percentages of the Plan's assets in Reliant securities was not prudent, should have ceased purchasing Reliant stock and liquidated the Plan's Reliant stock holdings, and breached their fiduciary duties by misrepresenting Reliant's financial condition in Plan documents that incorporated Reliant's financial statements on file with the SEC.[71] In granting summary judgment for the defendants, the district court concluded that the defendants did not have discretion under the Plan to terminate the fund or halt investments in Reliant stock and thus could not be liable for breach of fiduciary duty.[72] The district court also held that the alleged financial misrepresentations were made by Reliant in its corporate capacity and not its ERISA fiduciary capacity and thus could not support an ERISA fiduciary duty claim.[73]

The Fifth Circuit affirmed the district court's summary judgment.[74] It held that the plaintiffs' first claim, which alleged that the defendants breached their fiduciary duties by investing "such massive amounts or such a large percentage of [the Plan's] assets" in Reliant stock, was a "failure to diversify" claim and was thus barred by 29 U.S.C. § 1104(a)(2).[75] This provision confers a statutory exemption from the diversification requirement for eligible individual account plans that invest in the company's own securities.[76]

The Fifth Circuit also concluded that even if a fact issue existed as to whether the defendants had a fiduciary duty to override the Plan terms and halt investments in Reliant (or had discretion to do so), the evidence failed to overcome the "presumption of prudence" outlined in *Moench v. Robertson*.[77] The court held that "there ought to be persuasive and analytically rigorous facts demonstrating that reasonable fiduciaries would have considered themselves bound to divest," reasoning that "[a] fiduciary cannot be placed in the untenable position of having to predict the future of the company's stock performance."[78] Finally, the court concluded that the plaintiffs failed to identify any misrepresentations made by the defendants in an ERISA fiduciary capacity, noting that the alleged misrepresentations were all contained in Reliant SEC filings that were made in Reliant's corporate capacity.[79]

In *Galey v. World Marketing Alliance*,[80] the Fifth Circuit affirmed the denial of a brokerage firm's motion to compel arbitration. The plaintiffs filed suit against World Marketing Alliance and World Marketing Alliance Securities (collectively, "WMAS") in Mississippi state court, asserting that WMAS caused them to suffer losses in allegedly unsuitable investments.[81] WMAS removed the case to the Northern District of Mississippi and moved to compel arbitration pursuant to the plaintiffs' account agreement.[82] The district court denied the motion on the ground that WMAS had allowed its NASD membership to lapse, which precluded it from seeking arbitration under NASD Rule 10301.[83]

The Fifth Circuit affirmed, holding that the arbitration agreement's statement requiring "arbitration in accordance with the rules then in effect of the [NASD]" foreclosed the parties from arbitrating in a non-NASD forum.[84] The Fifth Circuit also rejected WMAS's arguments that the parol evidence rule prohibited consideration of the fact that WMAS's membership had lapsed, and that NASD Rule 10301 was merely a "minor consideration that should be severed in favor of the controlling intent of the parties to settle any and all disputes through arbitration."[85] The court noted that Rule 10301 was adopted to serve the "critical purpose" of protecting customers from "defunct" firms that were less likely to pay an arbitration award and is "not simply a minor logistical consideration ancillary to the arbitration agreement . . . ."[86]

In *Korman & Associates, Inc. v. United States*,[87] the Fifth Circuit addressed whether a family trust's obligation to close a short sale is a "liability" for purposes of Internal Revenue Code section 752. The case involved a series of prearranged transactions between the family

trust, two limited partnerships, and an individual, which were executed for purposes of obtaining tax benefits by offsetting a capital loss against future income and capital gains.[88] After opening a brokerage account with a $2 million cash deposit, the trust generated proceeds of $102.5 million by executing a short sale of T-Notes on December 27, 1999.[89] Later that day, the trust then transferred the brokerage account to one of the limited partnerships in exchange for a 99.99% limited partnership interest in that partnership, and then transferred its limited partnership interest to another limited partnership (GMK) on December 28, 1999 in return for a 99.99% interest in that partnership.[90] On December 30, 1999, GMK sold its 99.99% interest to an individual, Brian Czerwinski, for a $1.8 million promissory note.[91] Czerwinski then closed the short sale by purchasing $102.7 million in T-Notes.[92]

Despite the fact that the short sale resulted in an actual loss of only approximately $200,000 (*i.e.*, the difference between the $102.5 million received when the short position was opened and the $102.7 million paid to close the position), the trust claimed a $102.6 million short-term capital loss on the transaction.[93] The trust then carried over the majority of its pro rata share of GMK's loss to offset $1.1 million in short-term capital gains and $585,000 in long-term capital gains during tax year 2001.[94]

The Fifth Circuit affirmed the district court's summary judgment grant in favor of the government. After considering prior IRS revenue rulings and finding them persuasive, the Fifth Circuit agreed that the obligation to replace securities borrowed in a short sale should be treated as a liability for purposes of section 752 – and, by extension, that the trust should not be permitted to claim a $102.6 million short-term capital loss on a transaction that resulted in an actual financial loss of only $200,000.[95] The court opined that "[t]he Appellants' premeditated attempt to transform this wash transaction (for economic purposes) into a windfall (for tax purposes) is reminiscent of an alchemist's attempt to transmute lead into gold."[96]

In *Motient Corp. v. Dondero*,[97] the Fifth Circuit addressed whether section 13(d) of the Securities Exchange Act provided a private right of action for money damages. This provision was added by Congress in 1968 as part of the Williams Act, which was intended to "give needed information to investors in target corporations in order to protect them from takeover bidders . . . ."[98] In the underlying lawsuit, Motient sued James Dondero, the president of an investment company that was the "ultimate parent entity" for several other funds (the "Highland Entities"), for allegedly making false or misleading statements in a series of Schedule 13D amendments that were critical of Motient's board of directors.[99] The lawsuit sought both monetary and injunctive relief.[100] The district court ultimately dismissed the complaint with prejudice, and Motient appealed.[101]

The Fifth Circuit affirmed the district court's holding that section 13(d) did not provide a private right of action for money damages, noting that no other circuit court has recognized such a right.[102] The court held that the remaining claims for injunctive relief should be dismissed without prejudice on mootness grounds because the proxy fight at issue in the lawsuit had concluded.[103]

In *Luskin v. Intervoice-Brite Inc.*,[104] the Fifth Circuit reaffirmed its holding in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*[105] that plaintiffs must prove loss causation by a preponderance of the evidence to certify a Rule 10b-5 class action.[106] *Luskin* was a putative Rule 10b-5 class action filed in the Northern District against Intervoice-Brite and certain of its officers, claiming that they overstated the financial benefits of the merger between Intervoice, Inc. and Brite Voice Systems, Inc. and made other misrepresentations.[107] After the Fifth Circuit partially reversed the district court's Rule 12(b)(6) dismissal, the district court granted the plaintiffs' motion for class certification without determining whether loss causation was established.[108] The defendants then took an interlocutory appeal.[109]

The Fifth Circuit vacated the district court's certification order and remanded for a determination of whether the plaintiffs had established loss causation.[110] The plaintiffs argued that *Oscar* should be limited to situations where the alleged corrective disclosure is accompanied by other negative disclosures that do not relate to the alleged fraud.[111] The Fifth Circuit found no basis for making such a distinction, holding that "[t]here is no reason why the concerns stated in *Oscar* do not equally apply to cases in which only one negative disclosure is at issue."[112] Because the plaintiffs represented that they may have other relevant and admissible evidence that could support a finding of loss causation, the Fifth Circuit opted to remand the case to allow the parties to litigate the issue in the district court.[113]

The Fifth Circuit also issued several opinions in the various Enron civil and criminal actions. In *United States v. Yeager*,[114] the court rejected arguments by three former Enron Broadband Services ("EBS") executives that their acquittals on various fraud and insider trading counts precluded the government from re-indicting them on certain other counts where the jury failed to reach a unanimous verdict. The defendants, Scott Yeager, Rex Shelby, and Joseph Hirko, were tried on a series of securities fraud, insider trading, wire fraud, conspiracy, and money laundering charges stemming from their activities at EBS.[115] The jury acquitted Yeager of the conspiracy, wire fraud, and securities fraud counts, Hirko of certain insider trading and money laundering counts, and Shelby of certain insider trading counts.[116] The court also granted Shelby's motion for judgment of acquittal on the money laundering counts and the wire fraud counts.[117] The jury failed to reach a verdict on the remaining counts, and the district court declared a mistrial.[118] After the government re-indicted each defendant on the mistried counts, the defendants unsuccessfully moved to dismiss some of the indictments on collateral estoppel grounds, from which this appeal followed.[119]

The Fifth Circuit affirmed the denial of the defendants' motions to dismiss.[120] As to Shelby, the court held that the jury's

acquittal on the insider trading counts relating to his sale of Enron stock during the summer of 2000 did not preclude the government from retrying him on various insider trading counts relating to trades that Shelby made earlier in 2000, or on the securities fraud count.[121] The court noted that the jury could have distinguished between the two sets of trades and could have determined that the later trades were not motivated by insider information without reaching the same conclusion as to the earlier trades.[122] The court also noted that "using inside information" is not an element of the securities fraud count, and that a jury's finding that Shelby did not use inside information therefore would not foreclose a retrial on securities fraud.[123] Finally, the Fifth Circuit held that the district court's Rule 29 acquittals on the wire fraud counts did not estop the government from retrying him for securities fraud or insider trading because whether Shelby used interstate wire communications (which was the basis for the wire fraud acquittals) was not an element of securities fraud or insider trading.[124]

The Fifth Circuit also rejected Hirko's argument that his acquittal on the money laundering charges precluded retrial of the remaining securities fraud, wire fraud, and insider trading counts.[125] Hirko argued that because he stipulated to the other elements of money laundering, the jury must therefore have found that he had not committed "a specified unlawful activity," which the district court defined as "wire fraud" or "fraud in the sale of securities."[126] The Fifth Circuit disagreed, holding that the "hung" result on the underlying wire fraud and securities fraud counts required the jury to acquit on the money laundering charge, since the jury was required to find that he committed those acts before it could convict him of money laundering.[127] As to Yeager, the Fifth Circuit agreed that the jury necessarily concluded that he did not have insider information when it acquitted him of securities fraud, but nonetheless held that collateral estoppel did not bar retrial of the insider trading charges because the jury hung on those counts.[128] The Fifth Circuit concluded that the defendant failed to meet his burden of demonstrating that the jury necessarily resolved the issue, noting that "if the jury irrationally came to two inconsistent conclusions, we cannot say that it came to any definitive conclusion" about whether Yeager traded on inside information.[129]

In *In re Enron Corporation Securities, Derivative, and ERISA Litigation*,[130] the Fifth Circuit affirmed the district court's dismissal of ten state law securities actions under the Securities Litigation Uniform Standards Act ("SLUSA").[131] Nine of the cases had been filed in state court and removed to federal court based on "related to" bankruptcy jurisdiction under 28 U.S.C. § 1334(b).[132] The cases were then consolidated in the Southern District of Texas pursuant to the Multi-District Litigation ("MDL") statute, 28 U.S.C. § 1407.[133] The tenth case was filed directly in the Southern District of Texas.[134] The district court concluded that it had jurisdiction under section 1334(b) and held that SLUSA preempted the plaintiffs' claims.[135]

The Fifth Circuit affirmed the district court's decision on both counts. It first rejected the argument that the district court's "related to" bankruptcy jurisdiction expired once Enron's bankruptcy plan was confirmed, noting that the plaintiffs "cannot point to a single case in which we have held that plan confirmation divests a District Court of bankruptcy jurisdiction over pre-confirmation claims based on pre-confirmation activities that properly had been removed pursuant to 'related to' jurisdiction. We likewise find none."[136] The court thus held that the district court properly retained the case after removal.[137]

The Fifth Circuit also concluded that SLUSA preempted the plaintiffs' state law claims. Congress had enacted SLUSA to prevent plaintiffs from evading the PSLRA's requirements by filing their claims in state court.[138] Noting that SLUSA preemption "should be interpreted broadly to accomplish the goals of the PSLRA," the court had little difficulty finding the plaintiffs' claims fell within SLUSA's preemptive reach.[139] Under SLUSA, a group of lawsuits constitutes a "covered class action," and is thus preempted, if: (1) the suits are "pending in the same court;" (2) the suits involve "common questions of law or fact;" (3) "damages are sought on behalf of more than 50 persons;" and (4) "the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose."[140] The court observed that all ten suits were pending in the same court; that the cases involved virtually identical questions of law and fact; that the cases collectively sought damages on behalf of more than 50 persons, and that the plaintiffs in each case were represented by the same counsel, filed joint motions and nearly identical discovery responses, provided a single damages figure for all ten cases, and acted in unison throughout the litigation.[141] Accordingly, the cases fit squarely within SLUSA and were preempted.[142]

The Fifth Circuit also rejected the plaintiffs' arguments that SLUSA was solely a removal statute and not a preemption statute (holding that there is "no question" that SLUSA serves both functions) and that SLUSA required that the cases be pending in the same state court before they are removed (which "flies in the face" of the "covered class action" provision).[143] The court likewise rebuffed the plaintiffs' contention that the MDL statute should not be used to create a "covered class action," noting that plaintiffs voluntarily chose to act in unison following consolidation and thus created the conditions for SLUSA preemption on their own.[144] The Fifth Circuit thus affirmed the district court's decision in its entirety.

In *Newby v. Enron Corp.*,[145] the Fifth Circuit affirmed the district court's dismissal of a federal securities fraud class action suit filed against Kenneth Lay and three other officers and directors of EOTT Energy Partners, L.P. ("EOTT"), the sole general partner of an Enron subsidiary called EOTT Energy Corporation ("EOTT Energy").[146] Plaintiff Lila Ward originally filed the lawsuit on February 11, 2003.[147] The *Ward* case was later consolidated with *Newby v. Enron Corp.*[148] and was stayed under the Bankruptcy Code and PSLRA.[149] The district court appointed lead plaintiffs and counsel in the *Ward* action on February 17, 2005.[150] On August 16, 2005, counsel for two of the defendants notified counsel for the plaintiffs that their clients had not been served and requested that

they be dismissed.[151] Lead plaintiffs' counsel subsequently determined that none of the defendants had been served.[152] On December 20, 2005, more than 120 days after being notified that two defendants had not been served, the lead plaintiffs moved pursuant to Fed. R. Civ. P. 4(m) for an additional 60 days to effect service.[153] The district court denied the motion and dismissed the case, finding that the plaintiffs failed to demonstrate good cause for extending the 120-day deadline provided by Fed. R. Civ. P. 4.

The Fifth Circuit affirmed, holding that the district court did not abuse its discretion in finding that the lead plaintiffs lacked good cause to extend the 120-day deadline.[154] The court concluded that the reasons lead counsel offered for the delay – i.e., confusion over the stays, unawareness that service had not been effected, and the prolonged length of time before the district court appointed lead plaintiffs – were insufficient to meet the "excusable neglect" threshold needed to show good cause, "especially considering the length of delay in effecting service and the continued delay after learning of defects in service."[155] The court further held that good cause was not established merely because the statute of limitations had run.[156]

The Fifth Circuit also issued several opinions addressing the rights and responsibilities of class members who do not want to participate in a classwide settlement. In *Silvercreek Management, Inc. v. Banc of America Securities, LLC*,[157] the Fifth Circuit rejected a class member's request to extend the opt-out deadline for claims against Banc of America Securities LLC and Bank of America Corporation (collectively, "BOA") arising out of the Enron collapse.[158] Silvercreek's lawsuits against BOA had been consolidated into the *In re Enron Corp. Securities Litigation* action.[159] On April 25, 2005, two weeks after the final approval hearing and nearly one month after the March 28, 2005 opt-out date, Silvercreek filed an opt-out request and a motion to extend the opt-out deadline pursuant to Fed. R. Civ. P. 60(b).[160] The district court denied the motion and held that Silvercreek failed to demonstrate excusable neglect.[161] Noting that Silvercreek's counsel had been served with numerous briefs and notices regarding the approval hearing and opt-out date through the Enron securities litigation service system, the Fifth Circuit affirmed the district court's decision.[162] The Fifth Circuit also held that Silvercreek had waived its claim regarding the alleged inadequacy of the Enron litigation service system by failing to raise this issue in the district court.[163]

In *Courtney v. Andersen*,[164] the Fifth Circuit affirmed a summary judgment dismissing a shareholder's lawsuit that was filed nearly two years after the Southern District of Texas had approved a classwide settlement disposing of his claims.[165] The court held that the settlement release (which provided that class members who accept the settlement release all claims "arising out of or related, directly or indirectly, to the purchase, acquisition, exchange, retention, transfer or sale of, or investment decision involving, any Waste Management security during the class period") was not ambiguous and rejected the plaintiff's "unilateral mistake" argument.[166] The opinion noted that the plaintiff was a "sophisticated investor" who "was in the best position to determine whether the settlement was advantageous to him."[167]

In *Feder v. Electronic Data Systems Corp.*,[168] the Fifth Circuit held that an objector to a securities class action settlement must provide some evidence that he is actually a class member to have standing to object.[169] The appellant had submitted a written objection to the classwide settlement of the Electronic Data Systems Corporation ("EDS") securities litigation.[170] The objector, however, provided no evidence that he was an EDS shareholder aside from his bare assertion (and the assertion of his counsel) that he had purchased or otherwise acquired EDS securities during the class period.[171] The Fifth Circuit held that a party challenging a class action settlement bears the burden of establishing its standing to object, and that "[i]n this case, where the proof of claims period has closed and the settlement has been finally approved by the district court, the burden of proving class membership cannot be satisfied by the appellant's unsupported assertions . . . ."[172] The court concluded that "the right to object to settlement in a securities class action must rest on something more than the sort of bare assertions of stock-ownership" made in this case.[173]

In *Sudo Properties, Inc. v. Terrebonne Parish Consolidated Government*,[174] the Fifth Circuit reversed a summary judgment in a securities case and held that the plaintiffs did not sufficiently establish inquiry or constructive notice.[175] The operative events began in early 2002, when the plaintiffs decided to invest in a corporation ("Houma Sports") that was set up by a Terrebonne Parish official for the purpose of owning and operating an indoor football team.[176] Before the plaintiffs made their investment, the Parish official provided financial projections estimating an annual net profit of at least $142,346.[177] The plaintiffs later discovered that Houma Sports' expenses were significantly higher than the Parish had represented, and the venture ultimately lost more than $900,000 during the three-year term of its lease with the Parish's civic center.[178] In 2004, the plaintiffs uncovered an audio tape of an April 2002 Parish board meeting allegedly revealing that the official had misrepresented the financial condition of Houma Sports to ensure that the civic center would have them as a tenant.[179]

Thereafter, the plaintiffs filed suit and asserted federal Securities Act and Exchange Act claims as well as claims under Louisiana state law.[180] The district court granted summary judgment on statute of limitations grounds and held that the plaintiffs were on notice of their claims in 2002, when they first discovered the significant disparities between the Parish's projections and Houma Sports' actual performance.[181]

The Fifth Circuit rejected the district court's conclusion that notice of these disparities was sufficient to trigger onset of the limitations period under federal or state law.[182] According to the Fifth Circuit, the mere fact that the Parish's projections had been

"grossly incorrect" was insufficient, standing alone, to place plaintiffs on notice of their claims as a matter of law.[183] The fact that an estimate turns out to be inaccurate does not necessarily mean that fraud occurred.[184] In the Fifth Circuit's view, it was not until the plaintiffs uncovered the board transcript in 2004 that they had a concrete reason to suspect that the Parish had made deliberate misstatements.[185] The court thus reversed the summary judgments on both the federal and state claims.[186]

In *REIT v. Hartman*,[187] the Fifth Circuit held that a Maryland real estate investment trust ("REIT") lawfully adopted a series of defensive measures in anticipation of a takeover attempt by its former Chairman and CEO.[188] To make such a takeover more difficult, the REIT's board of trustees repealed a bylaw provision that permitted shareholders to remove trustees by majority written consent.[189] The trustees also opted in to the Maryland Unsolicited Takeover Act (the "MUTA").[190] The REIT's board had previously sued the former CEO in Texas state court for breach of fiduciary duty in October 2006, citing a series of alleged misdeeds, conflicts of interest, and disclosure failures.[191] After the state court granted multiple injunctions that effectively forced him to cede control, the former CEO resigned from the board on October 27, 2006.[192] One month later, the ex-CEO filed a consent solicitation statement ("CSS") seeking to replace the trustees with his own slate.[193] The REIT's board then filed suit in the Southern District of Texas to enjoin the solicitation.[194] The district court concluded that the board's defensive measures were proper and granted the injunction.[195]

The Fifth Circuit affirmed, although it cautioned that its holding was limited to the specific facts of the case and declined to issue a written opinion.[196] While the bylaws gave the board exclusive authority to make amendments, the Fifth Circuit disagreed with the board's argument that its authority to amend was unlimited, cautioning that "[n]o bylaw may excuse a board's breach of a fundamental shareholder right or totally obviate a board's duties to its shareholders."[197] Nonetheless, the Fifth Circuit held that the amendment was amply justified by the REIT's concerns over the ex-CEO's alleged misconduct and would survive review even if the business judgment rule's deferential standard did not apply.[198] In addition, Maryland's REIT statute expressly stated that directors have no duty to refrain from opting in to the MUTA.[199] The court also rejected the former CEO's argument that the MUTA opt-in was procedurally defective because he had appointed three of the four trustees, which the ex-CEO claimed rendered them non-independent.[200] Because the board members had been re-nominated by the board after their original nomination by the ex-CEO, any "taint" stemming from their original nomination by the ex-CEO had dissipated.[201] Accordingly, the MUTA opt-in was procedurally sound, and the Fifth Circuit affirmed the district court's judgment.[202]

ENDNOTES

1 *Gerard Pecht is a partner in the Houston office of Fulbright & Jaworski L.L.P., and Peter Stokes is a senior associate in the Austin office of Fulbright & Jaworski, L.L.P.*

2 127 S. Ct. 2499 (2007).

3 No. 06-30908, __ F.3d __, 2008 WL 2894793 (5th Cir. July 29, 2008).

4 *Id.* at *1-2.

5 *Id.* at *2.

6 *Id.* at *1.

7 *Id.* at *15.

8 *Id.* at *3.

9 *Id.*

10 *Id.* at *4.

11 *Id.*

12 *Id.* at *5.

13 *Id.*

14 *Id.* at *4.

15 *Id.* (citing 495 F.3d 753, 756-57 (7th Cir. 2007)).

16 *Id.* (quoting *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 353 (5th Cir. 2002)).

17 *Indiana Electrical*, __ F.3d __, 2008 WL 2894793, at *7-9.

18 *Id.* at *8.

19 *Id.* at *7-9.

20 *Id.* at *10.

21 *Id.*

22 *Id.* at *12-13 (quoting *Abrams v. Baker Hughes Inc.*, 292 F.3d 424, 435 (5th Cir. 2002)).

23 *Indiana Electrical*, __ F.3d __, 2008 WL 2894793, at *12.

24 *Id.*

25 *Id.* at *13.

26 *Id.* at *14.

27 *Id.*

28 497 F.3d 546 (5th Cir. Aug. 21, 2007).

29 *Id.* at 549-50.

30 *In re Integrated Electrical Services, Inc. Secs. Litig.*, No. Civ.A. 4:04-CV-3342, 2006 WL 54021, at *2 (S.D. Tex. Jan. 10, 2006).

31 *Id.* at *4-5.

32 *Central Laborers*, 497 F.3d at 555.

33 *Id.* (quoting *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 867 (5th Cir. 2005)).

34 497 F.3d at 552.

35 *Id.*

36 *Id* at 553.

37 *Id.*

38 *Id.*

39 *Id.* at 555.

40 *Id.*

41 *Id.*

42 *Id.* at 556.

43 No. 06-11368, 254 Fed. Appx. 335 (5th Cir. Nov. 12, 2007).

44 *Id.*

45 *In re SourceCorp Secs. Litig.*, Case No. 3:04-cv-02351-N, Dkt. #54 (N.D. Tex.).

46 *Id.*

47 254 Fed. Appx. 335.

48 No. 06-11093, 253 Fed. Appx. 253 (5th Cir. Sept. 18, 2007).

49 *Id.* at 254-55.

50 *Id.* at 254.

51 *Id.*

52 *Flaherty & Crumrine Preferred Income Fund Inc. v. TXU Corp.*, No. 3:05-CV-1784-G, 2008 WL 918339 (N.D. Tex. Apr. 4, 2008).

53 No. 07-60509, 265 Fed. Appx. 317 (5th Cir. Feb. 13, 2008).

54 265 Fed. Appx. at 318-19.

55 *Id.*

56 *Id.*

57 *Id.* at 320-21.

58 *Id.* at 319-21 (quoting 18 U.S.C. §1514A(a)).

59 514 F.3d 468 (5th Cir. 2008).

60 *Id.* at 474.

61 *Id.* at 475-76.

62 *Id.* at 476-77.

63 *Id.* at 478.

64 *Id.*

65 *Id.* at 478-79.

66 *Id.* at 480-82.

67 *Id.* at 480.

68 526 F.3d 243 (5th Cir. 2008).

69 *Id.* at 246-27.

70 *Id.* at 247.

71 *Id.* at 247-48.

72 *Id.* at 248.

73 *Id.*

74 *Id.*

75 *Id.* at 249.

76 *Id.*

77 62 F.3d 553, 571 (3d Cir. 1995).

78 526 F.3d at 256.

79 *Id.* at 257.

80 510 F.3d 529 (5th Cir. 2007).

81 *Id.* at 531.

82 *Id.*

83 *Id.*

84 *Id.* at 532-33.

85 *Id.*

86 *Id.*

87 527 F.3d 443 (5th Cir. 2008).

88 *Id.* at 445-46.

89 *Id.* at 447.

90 *Id.* at 448.

91 *Id.*

92 *Id.*

93 *Id.*

94 *Id.*

95 *Id.* at 459-63.

96 *Id.* at 458.

97 529 F.3d 532 (5th Cir. 2008).

98 *Id.* at 536.

99 *Id.* at 533-35.

100 *Id.* at 536.

101 *Id.* at 535.

102 *Id.* at 536.

103 *Id.* at 537-38.

104 No. 06-11251, 261 Fed. Appx. 697 (5th Cir. Jan. 8, 2008).

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106 261 Fed. Appx. at 701.

107 *Id.* at 698.

108 *Id.* at 698-99.

109 *Id.*

110 *Id.* at 702.

111 *Id.* at 701.

112 *Id.* at 702.

113 *Id.*

114 521 F.3d 367 (5th Cir. 2008).

115 *Id.* at 369-70.

116 *Id.* at 370.

117 *Id.*

118 *Id.*

119 *Id.*

120 *Id.* at 369.

121 *Id.* at 372.

122 *Id.*

123 *Id.* at 374-75.

124 *Id.*

125 *Id.* at 375.

126 *Id.*

127 *Id.* at 376.

128 *Id.* at 378.

129 *Id.* at 378-81 (citing *United States v. Larkin*, 605 F.2d 1360, 1370 (5th Cir. 1979)).

130 No. 07-20051, __ F.3d __, 2008 WL 2689248 (5th Cir. July 10, 2008).

131 *Id.* at *1.

132 *Id.* at *3.

133 *Id.*

134 *Id.*

135 *Id.*

136 *Id.* at *6.

137 *Id.*

138 *Id.* at *7.

139 *Id.* at *8.

140 *Id.* (quoting 15 U.S.C. § 78bb(f)(5)(B)(ii)).

141 *Id.* at *11.

142 *Id.*

143 *Id.*

144 *Id.* at *12. The court also noted that 172 of the plaintiffs in the ten actions ended up in the Southern District as a result of direct removal or direct filing, rather than consolidation under the MDL statute. *See id.*

145 No. 06-20658, 2008 WL 2605118 (5th Cir. July 2, 2008).

146 *Id.* at *1.

147 *Id.*

148 No. 4:01-CV-3624.

149 *Id.*

150 *Id.*

151 *Id.*

152 *Id.*

153 *Id.*

154 *Id.* at *3.

155 *Id.*

156 *Id.*

157 No. 06-20026, __ F.3d __, 2008 WL 2640097 (5th Cir. July 7, 2008).

158 *Id.* at *1.

159 *Id.*

160 *Id.* at *2.

161 *Id.*

162 *Id.* at *2-3.

163 *Id.* at *3.

164 No. 07-20347, 264 Fed. Appx. 426 (5th Cir. Feb. 1, 2008).

165 *Id.* at 430.

166 *Id.*

167 *Id.*

168 No. 06-40735, 248 Fed. Appx. 579 (5th Cir. Sept. 25, 2007).

169 *Id.* at 581.

170 *Id.* at 580.

171 *Id.*

172 *Id.* at 580-81.

173 *Id.* at 581.

174 503 F.3d 371 (5th Cir. 2007).

175 *Id.* at 376-78.

176 *Id.* at 373.

177 *Id.* at 373-74.

178 *Id.* at 374-75.

179 *Id.* at 375.

180 *Id.* at 375-76.

181 *Id.* at 377-78.

182 *Id.* at 377-79.

183 *Id.*

184 *Id.*

185 *Id.*

186 *Id.*

187 No. 07-20315, 252 Fed. Appx. 631 (5th Cir. Oct. 26, 2007).

188 *Id.* at 638-39.

189 *Id.* at 634.

190 *Id.*

191 *Id.* at 633.

192 *Id.*

193 *Id.*

194 *Id.*

195 *Id.*

196 *Id.* at 638-39.

197 *Id.* at 634-35.

198 *Id.* at 635.

199 *Id.* at 636.

200 *Id.* at 637.

201 *Id.*

202 *Id.*

Analysis of Dispositive Issues in Stock Options Backdating Litigation

By Alexandra S. Fernandez[1] and Andrew W. Yung[2]

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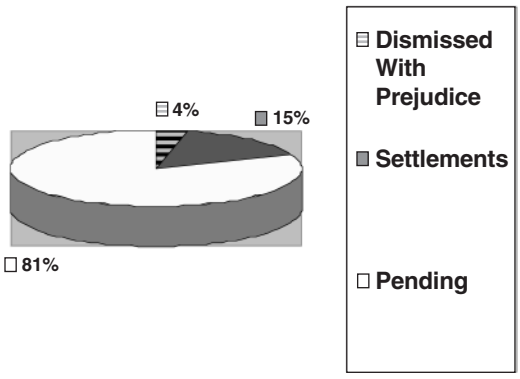
Introduction

This article analyzes the trends related to successful motions to dismiss derivative action complaints that allege stock options backdating. The article also addresses legal nuances, factual distinctions, and patterns that should be helpful to securities litigators. Officers and directors at over 160 companies have been sued in shareholder derivative actions based on allegations of stock options backdating since the Wall Street Journal's statistical expose came out in March 2006.[3] In addition to the more prevalent derivative actions, backdating allegations have spawned securities class action suits at over 30 of these companies, and suits filed by the SEC against officers and directors employed by at least 15 of the companies.[4] These director and officer defendants are not only accused of violating federal securities laws, but most also face state law allegations, such as fraud, breach of fiduciary duty, unjust enrichment, and gross mismanagement.

This onslaught of a new type of securities fraud claim propelled this D&O topic to the forefront of corporate counsel consciousness. As time has progressed, the din surrounding the backdating scandal has quieted somewhat. The large backdating settlements make news (such as the $900 million dollar settlement of the *UnitedHealth Group* lawsuit), but only a small fraction of the suits have settled. In fact, only 26 of the over 160 derivative suits have settled or are in the process of settling. Most of these settlements have cost defendants (and insurers where applicable) well below $10 million dollars and generally involve changes in corporate governance, payment of attorneys' fees, and the repayment of cash or cash equivalents to the company by individual defendants via relinquishment of options and option repricing.

The overwhelming majority of filed cases, however, are in a state of limbo, resulting in the lack of backdating headlines of late. The defendants in these cases have almost uniformly moved to dismiss the complaints. These defendants are waiting on courts to rule on their pending dismissal motions. Some seemingly fortunate defendants, whose motions were granted with leave to amend, are waiting for courts to rule on their second or even third motions to dismiss. A brief examination of the mechanics of backdating ("a backdating derivative primer") and other resources can be found at http://scottyung.com/alexandra_fernandez.html.

Dispositions of Derivative Backdating Lawsuits to Date:



Backdating Suits in Texas

Although most such cases are litigated outside the state, Texas has a small microcosm of the backdating litigation. As discussed below, Texas

courts have been far more inclined to grant dismissals, and Texas parties have reached settlement with greater dispatch than nationally.

In the *Affiliated Computer Systems* derivative litigation the defendants' motions to dismiss were granted in part, and the remaining defendants are awaiting rulings on pending motions to dismiss in the Northern District of Texas (No. 06-cv-1110). The defendants in the *Microtune* derivative litigation were successful in their motion to dismiss in the Eastern District of Texas (07-CV-43). The defendants in the *Michaels Stores* derivative litigation were successful in their motion to dismiss with prejudice in the Northern District of Texas (No. 06-cv-01083). The defendants in the *Fossil* derivative litigation are awaiting rulings on their motions to dismiss in the Northern District of Texas (No. 06-cv-01672). The defendants in *Cirrus Logic* are awaiting rulings on their motions to dismiss in the Western District of Texas (No. 07-cv-00212-SS), which earlier rejected the plaintiff's voluntary motion for dismissal because the court found that the federal forum was the only forum that could hear the securities claims.

With regard to settlements, the defendants in *Dean Foods* reached a resolution in Dallas County state court involving the payment of attorneys' fees and corporate governance reforms, the defendants in the *Cyberonics* derivative litigation settled the action for $650,000 in attorneys' fees in the Southern District of Texas (No. 06-cv-2671), the defendants in the *HCC Insurance Holdings* securities class action suit have reached a resolution of the action for $10 million in the Southern District of Texas (No. 07-0801), the defendants in the *HCC Insurance Holdings* derivative litigation settled the derivative claims for $3 million in attorneys' fees in the Southern District of Texas (No. No. 07-456), the defendants in Woodlands-based *Newpark Resources, Inc.* settled their securities class action and derivative litigation claims for less than $10 million in attorneys' fees in the Eastern District of Louisiana (06-CV-02150), and the plaintiffs in the *Arthrocare* derivative litigation voluntarily dismissed their claims after motions to dismiss were filed (but not yet ruled upon) in the Western District of Texas (No. 07-CA-009-SS).

Backdating Derivative Suits – What Do They Look Like?

Plaintiffs Have Asserted Similar Causes of Action

Plaintiffs usually assert several types of boilerplate backdating allegations based on federal securities law. The most prominent are violations of section 10(b) (and Rule 10b-5 promulgated thereunder), section 14(a) (and Rule 14a-9 promulgated thereunder), and section 20(a) of the Securities Exchange Act of 1934.

Typically, plaintiffs asserting section 10(b) claims allege that the defendants misrepresented to the market, through their SEC filings, that options were contemporaneously granted at the then-current, fair market value, that the value of the company's stock was inflated because of the misrepresentations, and that the company was damaged by its own purchase of inflated stock or issuance of unauthorized compensation to employees. To properly state a claim under section 10(b) and Rule 10b-5, a plaintiff must allege (1) a material omission or misrepresentation, or the use of a manipulative or deceptive device or contrivance; (2) scienter; (3) a connection with the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation (a causal connection between the misrepresentation or deceptive device and the loss).[5]

The typical section 14(a) claim alleges that the defendants are responsible for the issuance of certain proxy solicitations that contain false or misleading information. Plaintiffs allege, for example, that the proxies contained false grant dates, or omitted material facts, including that officers and directors were knowingly engaging in improper backdating. To properly state a claim under Rule 14a-9 and section 14(a), a plaintiff must allege (1) a false or misleading statement or omission of material fact; (2) that the misstatement or omission was made with the requisite level of culpability; and (3) that it was an essential link in the accomplishment of the transaction.[6]

Plaintiffs also tend to allege, under section 20(a), that the defendants, by virtue of their positions, were controlling persons at the company in question with the power and influence to cause the company to engage in the illegal conduct. Under section 20(a), joint and several liability can be imposed on persons who directly or indirectly control a violator of the securities laws. For there to be liability under section 20(a), a derivative plaintiff must allege (1) a primary violation of federal securities law; and (2) that the defendant exercised actual power or control over the primary violator.[7]

There are also several boilerplate backdating allegations based on state common law. They include unjust enrichment, breach of fiduciary duty, gross mismanagement, fraud, corporate waste, abuse of control, insider selling, rescission, and accounting. Generally, the law of the state in which the company was incorporated governs the state law claims. The essence of most state law claims is that the defendants, through their positions in the company, knew or were reckless in not knowing of the improper backdating scheme, which was in violation of the company's stock option plans, and personally profited from the backdating while damaging the company and shareholders. In evaluating motions to dismiss, most federal courts have not analyzed the plaintiffs' state law claims.[8]

Successful Defense Motions in Derivative Actions

As of the date this article was written, the authors identified 17 court decisions dismissing derivative backdating complaints based on the failure to make a litigation demand.[9] There have been at least 15 court decisions dismissing allegations of backdating, in whole or in part, for failure to state a claim on which relief can be granted.[10] Dismissals of backdating litigation have been granted for miscellaneous other reasons, including statute of limitations (*Glenayre Technologies*) or the plaintiffs' lack of standing (*Maxim*

Integrated Products and *Triquint Semiconductor*).[11] In comparison, there have been few denials (only seven) of motions to dismiss in derivative backdating cases (see *Maxim Integrated Products*, *Tyson Foods*,[12] *Staples*, *Inc.*, *Zoran Corporation*, *Getty Images*, *Quest Software* and *UnitedHealth Group*). Interestingly, the decisions involving the first three companies came out of the Delaware Chancery Court.

Defendants Should Easily Limit Timeframe of Allegations

Where courts have ruled, defendants have been overwhelmingly successful in arguing the application of the statutes of repose. Defendants have been successful in arguing against a continuing wrong theory, i.e., the argument that backdating is an ongoing fraudulent scheme that should toll the running of the statute of repose from the last misleading act or statement.[13] With regard to section 10(b) claims, the statute of repose is five years. To the extent that the claim is based upon the backdating itself, the period of repose starts on the date the option grant was made.[14] The statute of repose for section 14(a) is three years, and any claims arising from proxy statements filed three years prior to the date suit was filed are time barred.[15] Because section 20(a) claims depend on a primary violation of securities laws, the statute of repose applicable to section 20(a) is the same as that for the primary violation.[16] Those defendants awaiting rulings on their motions to dismiss can feel confident that the allegations will be narrowed if they exceed these limits.

Dismissals Based Upon Failure to Make a Litigation Demand

Under Federal Rule of Civil Procedure 23.1, a shareholder bringing a derivative action must "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority. . . and the reasons for plaintiff's failure to obtain the action or for not making the effort." In other words, a potential plaintiff in a derivative action must first make a demand upon a company's board of directors to allow them the opportunity to take action before the plaintiff brings suit. If the plaintiff does not do so, he must explain why, and his explanation must meet the applicable standards.

In most of these backdating cases, the companies involved were either incorporated in Delaware or follow Delaware law, and the explanation therefore must meet the Delaware standards for demand futility.[17] Delaware has two standards for excusing demand, the application of which depends on whether or not the board to which the plaintiff should have made the demand also made the decision that the plaintiff challenges. Where the board is the same, the rule in *Aronson* applies, and demand may be excused where a plaintiff makes particular allegations raising a reasonable doubt that (1) a majority of the board of directors in place at the time of the complaint is disinterested or independent, or (2) the challenged acts were the product of the board's valid exercise of business judgment.[18] Where the challenged transaction is not the decision of the board upon which plaintiff must seek demand the standard in *Rales v. Blasband* applies, which is the same as the first prong in the *Aronson* test.[19]

Plaintiffs seeking to avoid dismissal on demand failure frequently argue that, because a majority of the board meets one or more of the following factors, demand on the board was futile: (1) receipt of backdated stock options; (2) receipt of personal financial benefit from insider trading; (3) substantial likelihood of liability based on actions taken as a member of the compensation or audit committee; (4) substantial likelihood of liability based on approval or ratification of backdating; (5) substantial likelihood of liability based on the signing of false statements and/or proxies; and (6) substantial likelihood of liability based on the failure to prevent the wrongdoing from occurring. In addition, when the *Aronson* test applies, plaintiffs argue that backdating options cannot be a valid exercise of business judgment because backdating violates the company's stock option plans and wastes corporate assets. Defendants have been largely successful in attacking these arguments.

The threshold matter in backdating lawsuits is that the act of backdating, as opposed to accounting error, occurred. Defendants have found an avenue of success by attacking the adequacy of these allegations. Of the 17 decisions dismissing complaints on demand futility, at least nine were based, in whole or in part, on the failure to adequately plead backdating.[20] The defendants in these cases argued that the analysis and methodology employed by the plaintiffs was not particular enough to support the inference of backdating. In general, it is not enough for plaintiffs to allege that options were granted at a periodic low in stock price followed by a sharp jump in price; more facts, including comparison to other option grants, are needed to infer backdating.[21] For each allegedly backdated grant, plaintiffs commonly have offered (1) a pictorial graph tracking the stock price over a period of time, illustrating that the grant in question came at the bottom of a trough or "V" pattern; (2) a comparison of the price of the option grant in question to the weighted average closing price of the fiscal year; (3) a percentage amount illustrating the 20-day cumulative return; and (4) an allegation that the exercise price was one of the lowest of the month, quarter or year. This analysis does not follow the analysis used in the *Wall Street Journal's* study, which ranked the 20-day cumulative returns against all other possible grant dates within the year, nor does it follow the analysis of the CFRA (Center for Financial Research and Analysis), which compared the number of "at-risk" grants to the total number of grants.[22]

These analytical shortcomings were successfully argued in the THQ derivative litigation, where the defendants also pointed out that the 20-day cumulative returns alleged by the plaintiffs were relatively modest (all less than 49%).[23] Defendants have successfully defended against plaintiffs' argument that option grants falling on some of the lowest dates of the month and quarter are prima facie evidence sufficient to avoid dismissal. The trial court in *Openwave* pointed out that it is consistent with a random selection of grant dates for one date out of thirty-nine to fall at a monthly low, and

".60 of the stock options to fall on the lowest price of any given quarter (based on an average of 21.67 trading days per month and 65.01 trading days per quarter)."[24] Another powerful argument for defendants is that the grants were reported to the SEC a short time after the grant date.[25] In May 2007, the complaint in *Openwave* was dismissed with leave to amend for failure to adequately plead demand futility based on insufficient backdating allegations. The plaintiffs amended their complaint to include all reported option grants, but it was still insufficient because many of the grants were reported to the SEC (via Form 4's) less than 20 days later, rendering the 20-day cumulative return analysis meaningless.[26] Defendants have also had success arguing that certain grants were not backdated when they were made pursuant to an overall plan, as opposed to more random selection.[27]

Ryan v. Gifford, the most plaintiff-friendly opinion to date, discussed the exhaustive backdating allegations found in that unusual case. The key to successful defense arguments has often been differentiating the facts and backdating analysis from those laid out in *Ryan*. Luckily for defendants, that is fairly easy to accomplish, and the courts dismissing complaints for failing to adequately allege backdating have paved the way. In *Ryan*, every challenged option grant occurred during the lowest market price of the month or year in which it was granted.[28] The plaintiffs in *Ryan* relied heavily on a detailed report prepared by Merrill Lynch, which examined the 20-day cumulative return on *all* reported option grants, and the annualized returns from the reported grant dates versus the annualized return for the stock itself. The results of the analysis showed that the return on the allegedly questionable grants was ten times higher than the stock's annualized return.[29]

The decisions in *Ryan v. Gifford and Conrad v. Blank* are often cited by plaintiffs seeking to avoid dismissal for the proposition that because backdating is an inherently knowing act, members of the compensation committee are interested for purposes of demand futility analysis. However, defendants have been successful with at least two counter arguments. First, if the compensation committee can delegate some of its options-granting authority, making it possible that it may not have made every single decision in granting options, then merely alleging membership on the committee is not enough to demonstrate interest.[30] Second, even if the compensation committee cannot delegate some of its authority, several courts have found that merely pleading membership on the committee is not enough, even where it is charged with administering the option plans and determining the terms and conditions of each award.[31] These cases held that factual allegations explaining the role the defendant played, which director approved which grant, and whether the directors knew the options were backdated are necessary.

For similar reasons, defendants are largely successful in arguing that, for purposes of establishing "interest", membership on the audit committee, allegations of "approval" or "ratification" of backdating, allegations regarding signing false SEC filings, and allegations that backdating is not a valid exercise of the business judgment rule are insufficient. Defendants have been successful against these arguments where the plaintiffs do not allege facts indicating knowledge of backdating or the defendant's specific involvement. Demand futility must be pleaded with particularity. Courts have overwhelmingly rejected generalized allegations due to a lack of particularized facts.[32] For similar reasons, defendants have had success arguing that interest cannot be established by mere allegations that a defendant sold stock while in possession of material, non-public information.[33] Particularized facts regarding the directors' knowledge are needed to establish interest.[34] Furthermore, at least one case has addressed and rejected, for similar reasons, the argument that directors are interested by sins of omission (i.e., where they have been alleged to have failed to take action and permitted the wrongs alleged to have occurred).[35]

Decisions Granting Motions to Dismiss for Failure to Make a Litigation Demand:

WHO	WHERE	WHAT	PREJUDICE?
VeriSign	No. 06-4165 N.D. Cal.	*Rales*	No
THQ	No. CV 06-06935 C.D. Cal.	*Aronson*, insufficient backdating allegations	No
Computer Sciences	No. 06-05356 N.D. Cal.	*Rales*	Yes
Ulticom	No. 06-CV-3120 D.N.J.	*Aronson*	Yes
Bed Bath & Beyond	No. 603665/06 N.Y. Sup. Ct.	NY demand futility	No

Linear Technology	No. C-06-3290 N.D. Cal.	Inadequate allegations of backdating	No
CNET Networks	No. 06-03817 N.D. Cal.	*Aronson*, Inadequate allegations of backdating	No
Openwave Systems	No. C 06-03468 N.D. Cal.	*Aronson*, Inadequate allegations of backdating	No
Sycamore Networks	No. 2210-VCS Del. Chancery	*Rales*	?
Infosonics	No. 06cv1336 S.D. Cal.	Maryland demand futility	No
PMC-Sierra	No. C 06-05330 N.D. Cal.	*Aronson*, Inadequate allegations of backdating	No
F5 Networks	No. C06-794RSL W.D. Wash.	Inadequate allegations of backdating	No
Aspen Technology	No. 07-10354 D. Mass.	*Rales*	No
Finisar	No. C 06-07660 N.D. Cal.	Inadequate allegations of backdating, *Rales*	No
MIPS Tech.	No. C 06-06699 N.D. Cal.	*Rales*	No
Peet's Coffee and Tea	No. C 07-0740 N.D. Cal.	Inadequate backdating allegations	No
Microtune	No. 07-CV-43 E.D. Tex.	*Rales* or *Aronson*	No

Dismissal Based Upon Failure to State a Claim

Defendants in derivative actions have also found success in arguing that the plaintiffs failed to state a claim for which relief can be granted under Federal Rule of Civil Procedure 12(b)(6). Defendants can invoke the Private Securities Litigation Reform Act of 1995 ("PSLRA"), which requires that plaintiffs meet very exacting pleading standards for claims of securities fraud. There is no dispute that the PSLRA applies to allegations of section 10(b) violations. Some plaintiffs may dispute the application of the PSLRA as to section 14(a) violations. Of the nine derivative actions involving section 14(a) claims, three found that the PSLRA applied,[36] three assumed without deciding that the PSLRA applied,[37] one applied the heightened standards of Federal Rule of Civil Procedure 9(b),[38] and two did not reach the subject.[39]

In derivative backdating litigation, four arguments have been successful in dismissing section 10(b) claims. One successful avenue is familiar – arguing the insufficiency of the underlying backdating allegations. In at least one case, the plaintiff's entire complaint was dismissed due to the inadequacy of the backdating allegations after the defendant moved to dismiss for failure to state a claim.[40] In another, the section 10(b) claim was dismissed for failure to adequately plead scienter because the underlying inference of backdating was reasonable, but not compelling.[41]

Defendants have also found success in directly attacking the plaintiffs' section 10(b)'s scienter arguments. Under the PSLRA, plaintiffs must plead, with particularity, allegations giving rise to a strong inference that each defendant acted with deliberate recklessness or engaged in conscious misconduct.[42] In at least five derivative actions, the defendants were able to successfully argue that the plaintiffs' allegations were insufficient to survive dismissal, even when taken in light of all the factual allegations (including, in some cases, allegations of insider trading), because they relied on defendants' positions with the company and were not individualized as to all defendants.[43] In addition, the defendants in *VeriSign* persuaded the court that the section 10(b) claims were deficient as to loss causation because a plaintiff must allege that the loss resulted from a stock price drop caused by revelation of the "relevant truth," and VeriSign's stock increased after the relevant announcements.[44]

Defendants have also found success in dismissing section 14(a) claims. In at least four cases, the defendants effectively argued that the plaintiffs failed to allege transactional causation, i.e., the plaintiffs failed to allege that the company suffered a direct injury as

a direct result of the transaction that was at immediate issue in the proxy.[45] In *VeriSign* and *Michaels Stores*, the courts found that the plaintiffs failed to plead the required state of mind with sufficient particularity under the PSLRA. In other words, the plaintiffs failed to state a claim under section 14(a) because they did not plead particularized facts giving rise to a strong inference of negligence as to each defendant. Defendants who were not directors at the time any proxies were issued were also successful in dismissing section 14(a) claims against them, with prejudice, in at least one case.[46] Defendant directors in the same case successfully argued that the plaintiff's complaint was not sufficiently particular as to each remaining defendant because it failed to particularly attribute any false statements to the individual defendants.[47] In *Michaels Stores*, the court found that the alleged misrepresentations made in the company's statements were not incorporated into the proxy statements in question, and dismissed those claims accordingly. Several other derivative action section 14(a) claims have been dismissed in their entirety because they were time-barred.[48]

Most defense success against section 20(a) claims hinges upon the lack of a primary violation of sections 10(b) or 14(a).[49] However, defendants have been successful in at least two other cases in arguing that there was no primary violator alleged. In *VeriSign*, the court found that it was "logically impossible" for a corporation, on whose behalf a derivative action was brought, to also be a primary violator, and therefore, there were no allegations that the defendants controlled a primary violator.[50] In *Zoran*, the plaintiffs asserted section 20(a) claims against only two defendants, and because those two defendants were primary violators of section 10(b), the court dismissed the section 20(a) claims.[51]

Decisions Granting Motions to Dismiss for Failure to State a Claim:

WHO	WHERE	WHAT	IN PART?	PREJUDICE?
VeriSign	No. 06-4165 N.D. Cal.	§§10(b), 14(a), 20(a)- scienter, loss causation, reliance, limitations, negligence, control	No	No
Brocade Comm.	No. 06-cv-02786 N.D. Cal.	§16(b)	No	Yes
Apple	No. 06-4128 N.D. Cal.	§§10(b), 14(a), 20(a)- limitations, scienter	Yes	No
Quest Software	No. 06-6863 C.D. Cal.	§§10(b), 20(a)- scienter	Yes	No
Delta Petroleum	No. 06-cv-01797 D. Colo.	§§10(b), 14(a), 20(a)- insufficient backdating allegations	No	No
Ditechl[52]	No. 06-5157 N.D. Cal.	§§10(b), 14(a), 20(a)- insufficient backdating allegations, limitations	No	No
Atmel	No. 06-4592 N.D. Cal.	§§10(b), 14(a)- scienter, limitations	No	No
iBasis	No. 06-12276 D. Mass.	§14(a)- causation	No	Yes
Staples	No. 07-10193 D. Mass	§§10(b), 14(a), 20(a)- misstatements, scienter, insufficient backdating allegations, causation	No	No
Finisar	No. 06-07660 N.D. Cal.	§§ 10(b), 14(a), 20(a) allegations against one defendant	No	No
Microtune	No. 07-CV-43 E.D. Tex.	§§14(a), 10(b) – false statements, scienter, loss causation	No	Yes (in part)
Zoran	No. 06-cv-05503 N.D. Cal.	§20(a)- primary violators	Yes	No
Michaels Stores	No. 06-CV-1083 N.D. Tex.	§14(a), 20(a)- negligence, false statement, causation	No	Yes
Affiliated Computer Services	No. 06-CV-1110 N.D. Tex.	§§10(b), 14(a), 20(a)- scienter, causation	Yes	No

Other Backdating Litigation

Securities Class Action Suits

Although backdating claims are predominantly filed as derivative actions, several have been filed as securities class actions. In these cases, class representatives of the companies in question file suit on behalf of all relevant shareholders of the companies. Aside from the form of the lawsuits, securities class actions and derivative suits in these cases are very similar. Because plaintiffs in a class action are not suing on behalf of the company, the motions to dismiss do not discuss demand futility, but they do discuss failure to state a claim under Rule 12(b)(6) and the PSLRA. Plaintiffs in securities class actions assert the same section 10(b), 14(a) and 20(a) allegations as plaintiffs in derivative actions.

The following chart lists the successes and defeats of defendants' motions to dismiss securities class action complaints:

WHO	WHERE	WHAT	PREJUDICE?
		GRANTING MOTION TO DISMISS:	
Apple	No. 06-5208, N.D. Cal.	§§14(a), 20(a)- loss causation	No
Hansen Natural	No. CV 06-7599, C.D. Cal.	§§10(b), 20(a)- misstatements, scienter, materiality, loss causation	Yes
Amkor Technologies	No. 07-0278 D. Ariz.	§§10(b), 20(a)- loss causation, scienter	Yes
Mercury Interactive	No. 05-3395 N.D. Cal.	§§10(b), 20(a)- loss causation, scienter, repose	No
Witness Systems	No. 06-CV-1894 N.D. Ga.	§§10(b), 20(a)-scienter, loss causation	Yes
Jabil Circuit	No. 06-cv-01716 M.D. Fla.	§§10(b), 14(a), 20(a)- repose, insufficient backdating allegations, scienter, loss causation	No
		GRANTING IN PART:	
Brooks Automation	No. 06-11068, D. Mass.	§10(b)-scienter	No
Openwave Systems	No. 07 Civ. 1309 S.D.N.Y.	§10(b)-scienter	No
Quest Software	No. 06-6863 C.D. Cal.	§10(b)-scienter §20(a)-standing	No
Comverse Technology	No. 06-cv-1825 E.D.N.Y.	§10(b), 14(a)-unopposed	No
Juniper Networks	No. 06-04327 JW N.D. Cal.	§10(b)- scienter, repose	No
		DENYING MOTION TO DISMISS:	
Brocade Comm.	No. 05-02042 N.D. Cal.		
Monster Worldwide	No. 07 Civ. 2237 S.D.N.Y.		
UnitedHealth Group	No. 06-CV-1691 D. Minn.		

SEC and DOJ-Filed Suits

It is also important to be aware of other types of lawsuits born of the backdating scandal — civil enforcement actions filed by the SEC and criminal complaints filed by the Department of Justice. A review of the charges brought in these cases is instructive.

In deciding whether to recommend enforcement action, the SEC generally issues informal or formal inquiries to companies with potential backdating problems, or investigates companies that self-report to the SEC. Although the investigations are commonplace,[53] few SEC *enforcement actions* have been filed. In fact, the SEC has only filed charges against 17 companies (and/or certain of their executives), including Broadcom, Monster Worldwide, UnitedHealth Group, Maxim Integrated Products, KLA-Tencor, Juniper Networks, Brocade Communications Systems, SafeNet, Integrated Silicon Solution, Brooks Automation, Engineered Support Systems, Mercury Interactive, Apple, McAfee, Take-Two Interactive Software, Comverse Technology and Symbol Technologies.[54]

These lawsuits, which generally seek injunctions against securities fraud and civil penalties for reimbursement of ill-gotten gains, commonly allege section 10(b) and 14(a) violations, but also commonly allege violations of sections 13(a) and 13(b) of the 1934 Securities Exchange Act, and section 17(a) of the 1933 Securities Act. Several substantial settlements have been reached between the SEC and certain of these defendants, including a $468 million settlement with former CEO William McGuire of UnitedHealth Group (including a record-breaking $7 million civil penalty), a $12 million settlement with Broadcom, and an $800,000 settlement with CEO Gifford of Maxim Integrated Products.

The Department of Justice has filed criminal charges against executives of at least nine companies involved with the backdating scandal, including Brocade Communications Systems, SafeNet, Monster Worldwide, McAfee, Take-Two Interactive Software, Comverse Technology, Brooks Automation and Broadcom.[55] The penalties imposed in these suits are extremely serious. The former CEO of Brocade was sentenced to 21months in prison and ordered to pay a $15 million fine.[56] A former Vice President of Brocade was sentenced to four months in prison and ordered to pay a $1.25 million fine.[57] The former CFO of SafeNet was sentenced to six months in prison and ordered to pay a $1 million dollar fine.[58]

Potential Problems for Defendants

Generally speaking, defendants have had more successes than setbacks in terms of motions to dismiss backdating complaints, but the continuation of that trend remains to be seen. Many of these cases take a turn for the worse on slight factual distinctions or a judge's particular affinity for the *Ryan v. Gifford* opinion. Dismissals based on the failure to make a litigation demand are particularly dangerous to rely on, since a court can deem one "type" of defendant interested (for example, compensation committee members) and still dismiss the complaint because a majority of that type did not make up the board of directors. Furthermore, many of the courts granting motions to dismiss allow leave to amend, which prolongs the waiting game and adds the case to the list of "pending" litigation.

Dangers for defendants in these actions do not lie soley in the dismissal opinions. The action on the docket subsequent to the defendant-favorable April 2007 holding in the *CNET Networks* derivative litigation contains a few items defendants should be aware of. The court in that case (Judge Alsup) granted leave to amend after granting defendants' motions to dismiss. After the ruling, the court granted the plaintiffs' request for a stay in order to give them time to examine CNET's books and records to resolve whether the compensation committee delegated, or had the authority to delegate, stock option granting authority. After a dispute in the Delaware Chancery Court, CNET was ordered to make available all books and records, even those that predated the plaintiffs' stock ownership.

The next major event on the CNET docket came after the parties reached a tentative settlement agreement in the case. Judge Alsup denied the parties' motion for preliminary approval of settlement, stating that "the Court could not be in a position to evaluate a settlement until we know what claims are viable and what depositions, discovery, and damage assessments show about the strength and magnitude of those claims." After stating that the plaintiffs could not settle the claims until they proved they have standing to sue, Judge Alsup discussed the danger of the appearance of collusion, and referenced his similar denial of settlement in the *Zoran* backdating derivative litigation (filed the same day). Judge Alsup withheld approval of the proposed settlement in *Zoran* because he felt it was unfair to the shareholders. The terms of the settlement, similar to the terms in various other derivative settlements, included payment of attorneys' fees, repricing of options, and corporate governance reform. Similar settlements were reached in the backdating suits involving Dean Foods, Molex Incorporated, J2 Global Communications, Jabil Circuits, Cyberonics, Nabors Industries and HCC Insurance Holdings. How Judge Alsup's views on settlement will affect the pending derivative litigation remains to be seen. The *CNET* plaintiffs are currently on their third amended complaint.

Another area for defendants to keep an eye on is plaintiff requests for documents generated or reviewed by special litigation committees. Many companies have formed a special litigation committee in response to the backdating scandal in order to determine whether it was in the company's best interest to take legal action against any officers and directors. These committees then made reports to their respective boards of directors. In at least one case, the *Take-Two Interactive Software* derivative litigation, the court allowed the plaintiffs access to documents reviewed and relied upon by the committee, but did not allow the plaintiffs access to the working papers of the committee's counsel that were not communicated to the committee.[59]

Conclusion

With the bulk of backdating suits still pending, the outcome for hundreds of defendants remains to be seen. In light of all the motions to dismiss awaiting rulings as of early 2008, one would expect and hope that dozens more courts will render decisions by the end of 2008. Those defendants whose motions are denied will be parties to a new crop of securities case law that will inevitably be studied in law school classrooms across the country. Those defendants who are successful in their motions to dismiss no doubt are hoping the court dismisses with prejudice.

ENDNOTES

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3 Charles Forelle & James Bandler, *The Perfect Payday*, Wall St. J., March 18, 2006. *See* Kevin LaCroix, Counting the Options Backdating Suits, *at* http://dandodiary.blogspot.com/2006/07/counting-options-backdating-lawsuits.html (last visited April 15, 2008, 17:00 CST).

4 *See id.*; SEC Spotlight on: Options Backdating, *at* http://www.sec.gov/spotlight/optionsbackdating.htm (last visited April 15, 2008).

5 *E.g*, In re VeriSign, Inc., Derivative Litig., 531 F. Supp. 2d 1173, 1204 (N.D. Cal. 2007); *see also* 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

6 *E.g., VeriSign*., 531 F. Supp. 2d at 1211; *see also* 15 U.S.C. § 78n(a).

7 *E.g., VeriSign*., 531 F. Supp. 2d at 1213; *see also* 15 U.S.C. § 78t.

8 *But see Verisign*, 531 F. Supp. 2d 1173 (discussing the dismissal of various state law claims); In re Zoran, Corp., Derivative Litig., 511 F. Supp. 2d 986 (N.D. Cal. 2007) (granting, in part, defendants' motions to dismiss, dismissing claim for aiding and abetting breach of fiduciary duty because plaintiff claimed all of the defendants were primary breachers of fiduciary duty, and dismissing claims for constructive fraud, abuse of control, gross mismanagement and rescission because they are repackaged claims for breach of fiduciary duty).

9 These decisions involve the following companies: VeriSign, THQ, Computer Sciences, Ulticom, Bed Bath & Beyond, Linear Technology, CNET, Openwaves Systems, InfoSonics, PMC-Sierra, F5 Networks, Aspen Technology, Finisar, MIPS Technology, Microtune and Peet's Coffee & Tea.

10 These decisions involve the following companies: VeriSign, Apple, Quest Software, Delta Petroleum, Ditech, Atmel, iBasis, Staples, Finisar Corporation, Microtune, Zoran, Brocade, Michaels Stores, Affiliated Computer Systems.

11 Other derivative dismissals involve Mercury Interactive Corp., FLIR Systems, and Clorox.

12 The Tyson Foods backdating litigation involved allegations of backdating and stock option "spring-loading."

13 *E.g.*, In re Ditech Networks Derivative Litig., No. 06-5157, 2007 U.S. Dist. LEXIS 51524 at *22-23 (N.D. Cal. July 16, 2007); *Zoran*, 511 F. Supp. 2d at 1014; Stoll v. Ardizzone, No. 07 Civ. 00608, 2007 U.S. Dist. LEXIS 75769 at *2 (S.D.N.Y. October 9, 2007) ("pleading the existence of a "scheme" does not resurrect stale claims relating to proxy statements that are more than three years old at the time the action is filed; there is no "continuing violations exception [].").

14 *E.g.*, In re Atmel Corp. Derivative Litig., No. C 06-4592 JF, 2007 U.S. Dist. LEXIS 54058 at *20-21 (N.D. Cal. July 16, 2007).

15 *E.g., Ditech Networks*, 2007 U.S. Dist. LEXIS 51524 at *25-26; *Zoran*, 511 F. Supp. 2d at 1014.

16 *Atmel*, 2007 U.S. Dist. LEXIS 54058 at *26; Winters v. Stemburg, 529 F. Supp.2d 237 (D. Mass. 2008).

17 *But see* In re Infosonics Corp. Deriv. Litig., No. 06cv1336, 2007 U.S. Dist. LEXIS 66043 (S.D. Cal. Sept. 4, 2007) (applying less "permissive" Maryland law to the demand futility analysis).

18 Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

19 Rales v. Blasband, 634 A.2d 927, 933 (Del. 1993).

20 See the decisions involving THQ, CNET, Openwaves Systems, Linear Technology, PMC-Sierra, F5 Networks, Finisar, MIPS Technologies and Peet's Coffee & Tea.

21 See In re CNET Networks, Inc., 483 F. Supp. 2d 947, 958 (N.D. Cal. 2007), *citing* In re Linear Tech. Corp. Derivative Litig., No. C-06-3290, 2006 U.S. Dist. LEXIS 90986 at *3 (N.D. Cal. Dec. 7, 2006).

22 The authors do not suggest that these more rigorous analyses are any evidence of intent or could be adequate proof of any matter.

23 *Haw. Laborers Pension Fund v. Farrell*, No. CV 06-06935 ODW, 2007 U.S. Dist. LEXIS 77777 (C.D. Cal. Aug. 24, 2007).

24 In re Openwave Sys. Inc., Derivative Litig., No. C 06-03468 (N.D. Cal. February 12, 2008) (holding that the following option grant dates were not enough to infer a pattern of backdating: one on a monthly low, one on a quarterly low, one on the second lowest of the quarter, two on the fifth lowest dates of the month, and one on the seventh lowest date of the month).

25 *E.g., CNET*, 483 F. Supp. 2d at 958-962. The argument regarding grants reported to the SEC is most prevalent with regard to grants occurring after the enactment of the Sarbanes-Oxley Act of 2002, which required directors and officers transacting their company's stock to file a Form 4 a few days after the transaction. Prior to this act, companies had a 20 day window to report stock option grants.

26 In re Openwave Sys. Inc., Derivative Litig., No. C 06-03468, (N.D. Cal. February 12, 2008); In re F5 Networks, Inc., Derivative Litig., No. C06-794RSL, 2007 U.S. Dist. LEXIS 57464 (W.D. Wash. Aug. 6, 2007).

27 *E.g., CNET*, 483 F. Supp. 2d at 958-60.

28 *Ryan*, 918 A.2d at 354.

29 Other cases often cited by plaintiffs can be similarly distinguished. In *Zoran*, the backdating allegations were supported by an independent expert retained by plaintiffs. 511 F. Supp. 2d at 1003-06. In the *Staples* derivative litigation a more Merrill Lynch type of analysis took place, and eight out of twelve of the grants were made at the lowest trading price for the month. Conrad v. Blank, No. 2611-VCL (De. Ch. Sept. 7, 2007).

30 *E.g., CNET*, 483 F. Supp. 2d at 965; *Farrell*, 2007 U.S. Dist. LEXIS 77777; Desimone v. Barrows, 924 A.2d 908, 914 (Del. Ch. 2007); *see also* Linear Technology, No. C-06-3290, 2006 U.S. Dist. LEXIS 90986 (N.D. Cal., Dec. 7, 2006); F5 *Networks*, 2007 U.S. Dist. LEXIS 57464.

31 *Verisign*, 531 F. Supp. 2d at 1194 (stating further that the complaint alleged no facts explaining the role, if any, that each director played in the alleged wrongdoing, in terms of his service on one or more of the committees); *In re Finisar Corp. Deriative. Litig*., No. 06-cv-07660 (N.D. Cal. Jan. 11, 2008);

Wandel v. Eisenberg, No. 603665/06, 2007 N.Y. Misc. LEXIS 4086 (N.Y. Sup. Ct. May 18, 2007) (dismissing derivative litigation on behalf of Bed, Bath & Beyond for failure to particularly plead demand futility because, in part, membership on the compensation committee was conclusory and insufficient to establish interest).

32 *E.g., F5 Networks*, 2007 U.S. Dist. LEXIS 57464 at *13 (finding allegation of knowledge based on audit committee membership insufficient); *CNET*, 483 F. Supp. 2d at 966 (finding that where plaintiffs merely allege that approval was given without more, the facts do not support that the board was not independent or disinterested or that their decisions were not protected by the business judgment rule); *Verisign*, 531 F. Supp. 2d at 1193 (pointing out that "approval" or "ratification" can have varying definitions, and without more, these allegations are insufficient to support demand futility); In re Microtune Derivative Litig., No. 07-CV-43 (E.D. Tex. March 31, 2008).

33 *Verisign*, 531 F. Supp. 2d at 1190-91 (holding that insiders sell stock as a matter of course and particularized facts must be pleaded to adequately show interest); *Farrell*, 2007 U.S. Dist. LEXIS 77777 at *10-11; *Linear Tech*., 2006 U.S. Dist. LEXIS 90986 at *10-11.

34 *Verisign*, 531 F. Supp. 2d at 1190-91.

35 *Verisign*, 531 F. Supp. 2d at 1194-95 (rejecting the argument because it was not particularized as to any individual directors, and because it constituted a "failure of oversight" claim which requires a showing that the board had clear notice of wrongdoing and chose to ignore it).

36 *Verisign*, 531 F. Supp. 2d at 1211; Britton v. Parker, No. 06-cv-01797, 2007 US Dist. LEXIS 71346, *10-11 (D. Colo. Sept. 26, 2007) (Delta Petroleum); *Zoran*, 511 F. Supp. 2d at 1015.

37 In re Apple Computer Derivative Litig., No. 06-4128, 2007 U.S. Dist. LEXIS 89272, *17 (N.D. Cal. Nov. 19, 2007); Ditech Networks, 2007 U.S. Dist. LEXIS 51524, *26; Atmel, 2007 U.S. Dist. LEXIS 54058, *24-25.

38 Pedroli v. Bartek, No. 4:07-cv-43 (E.D. Tex. March 31, 2008).

39 Winters v. Stemberg, No. 07-10193-WGY (D. Mass. Jan. 4, 2008); In re iBasis, Inc. Derivative Litig., No. 06-12276-DPW (D. Mass. Dec. 4, 2007).

40 *Britton*, 2007 U.S. Dist. LEXIS 71346 (dismissing §§10(b), 14(a) and 20(a) claims); *see also* In re Ditech Networks, Inc. Derivative Litig., No. 06-5157 (N.D. Cal. July 26, 2007) (dismissing 10(b) claims for insufficient backdating allegations).

41 Winters v. Stemberg, No. 07-10193-WGY (D. Mass. Jan. 4, 2008)

42 *Verisign*, 531 F. Supp. 2d at 1206.

43 *VeriSign*, 531 F. Supp. 2d at 1205-06; *In re Apple Computer Derivative Litig.*, 2007 U.S. Dist. LEXIS 89272 at *24-25; *Atmel*, 2007 U.S. Dist. LEXIS 54058 at *17-18; *Ditech Networks*, 2007 U.S. Dist. LEXIS 51524 at *15-16; *Pedroli v. Bartek*, No. 4:07-cv-43 (E.D. Tex. March 31, 2008).

44 The defendants in *VeriSign* also successfully argued that the §10(b) claim was insufficient because plaintiffs did not plead reliance (the defendants who purportedly relied on the financial statements were also accused of knowing or recklessly disregarding the misleading nature of the financial statements).

45 *VeriSign*, 531 F. Supp. 2d at 1211-13; Winters v. Stemberg, No. 07-10193-WGY (D. Mass. Jan. 4, 2008); In re iBasis, Inc. Derivative Litig., No. 06-12276-DPW (D. Mass. Dec. 4, 2007) (finding that the harms alleged by plaintiffs predated the only proxy statement not time-barred); Hulliung v. Bolen, No. 06-cv-1083 (N.D. Tex. April 18, 2008) (*Michaels Stores* derivative litigation).

46 Pedroli v. Bartek, No. 4:07-cv-43 (E.D. Tex. March 31, 2008).

47 *Id*.

48 *Atmel*, 2007 U.S. Dist. LEXIS 54058, *24-25; *Ditech Networks*, 2007 U.S. Dist. LEXIS 51524, *26.

49 *E.g. Atmel*, 2007 U.S. Dist. LEXIS 54058, *25-26.

50 *VeriSign*, 531 F. Supp. 2d at 1213.

51 *Zoran*, 511 F. Supp. 2d at 1015.

52 The *Ditech* derivative litigation has been dismissed twice. The first complaint alleged securities law violations and was dismissed with leave to amend on July 16, 2007; the second involved state law claims and was dismissed with prejudice.

53 *See "Perfect Payday: Options Scorecard"*, Wall St. J., Sept. 4, 2007, *available at* http://online.wsj.com/public/ resources/ documents/info-optionsscore06-full.html (last visited April 15, 2008).

54 *SEC Spotlight on: Options Backdating*, http://www.sec.gov/spotlight/optionsbackdating.htm (last visited April 15, 2008).

55 *SEC Spotlight on: Options Backdating*, http://www.sec.gov/spotlight/optionsbackdating.htm (last visited April 15, 2008).

56 U.S. Dept. of Justice, Press Release, Jan. 16, 2008, available at http://www.usdoj.gov/usao/can/press/2008/2008_01_16_reyes.sentenced.press.html

57 U.S. Dept. of Justice, Press Release, March 19, 2008, available at http://www.usdoj.gov/usao/can/press/2008/2008_03_19_jensen.sentenced.press.html

58 U.S. Dept. of Justice, Press Release, Jan. 28, 2008, available at http://www.usdoj.gov/usao/nys/pressreleases/January08/argosentencingpr.pdf

59 In re Take-Two Interactive Software Derivative Litig., No. 06-5279, 2008 WL 681456 (S.D.N.Y. March 10, 2008).

Annual RICO Update

By Randy D. Gordon and Samuel E. Joyner[1]

Randy D. Gordon

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In the past year, the Fifth Circuit Court of Appeals and its various district courts saw a noticeable rise in civil RICO activity. The Fifth Circuit decided three cases, an increase of two cases from last year's update and three cases from the year before. The district courts decided 10 cases, up six cases from the 2007 update and two cases from 2006. This year also marked the first time in at least six years that a court in the Fifth Circuit imposed liability under the civil RICO statute.

Brokers and Attorneys Liable for Misleading Investors in Tax Shelter

In *Ducote Jax Holdings LLC v. Bradley*,[2] a group of investors sued a group of brokers and attorneys for colluding, soliciting, and inducing them to participate in a tax strategy that the Internal Revenue Service had found to be an unregistered tax shelter.[3] The investors contended that the purpose of the advisors' enterprise was to generate millions of dollars of fees by co-promoting and serving as a counterparty for certain contracts as part of an alleged tax savings strategy. The fees billed by the advisors were not based on time or effort expended working on the deal, but solely on the size of the transaction. According to the investors, the advisors devised the tax strategy and agreed to "provide a veneer of legitimacy to each other's opinion as to the lawfulness and tax consequences of the strategies . . . by agreeing to representations that would be made."[4]

The tax strategy at issue, commonly known as a "Son of Boss" transaction, was developed by Paul M. Daugerdas (then a partner in the former law firm of Jenkens & Gilchrist), Deutsche Bank AG, and Deutsche Bank Securities, Inc. in the mid to late 1990s. The transaction involved the purchase and sale of foreign exchange digital options known as "FX Contracts."[5] According to the investors, the advisors "induced them to enter into the transactions by representing that the tax strategies had been vetted by the law firm Jenkens & Gilchrist, and that this law firm would provide legal opinions assuring the [investors] that the tax strategies provided protections against penalties that the IRS could assess in the unlikely event that the IRS challenged the legitimacy of the tax strategies."[6] The investors claimed, however, that these opinion letters were "canned" long before clients were solicited and that the Jenkens & Gilchrist attorneys were not providing an "'independent' opinion letter, but rather an opinion letter as to the validity of its own tax shelter."[7]

The investors claimed that the advisors knew or should have known the transactions were illegal, based on several notices issued by the IRS before the tax strategies were promoted to them. Relying on the advisors for their tax and legal expertise, the investors participated in the transactions paying the advisors fees of approximately $1,033,500. Defendant American Express Tax and Business Services, Inc. prepared the investors' 2001 corporate and individual tax returns utilizing the losses generated by the strategies. Subsequently, the investors learned that the tax strategies were indeed illegal.[8]

In May 2004, the IRS announced the Son of Boss settlement initiative to encourage taxpayers, like the investors, to settle before IRS enforcement action. Under the terms of the settlement, the investors were required to pay the IRS all the claimed tax losses avoided by use of these transactions, all interest due, a ten percent penalty, and a loss of fifty percent of fees and other out-of-pocket transaction costs. Taxpayers not participating in the settlement would be assessed all tax and interest, plus a forty percent penalty and loss of all deductions.[9] After settling with the IRS, the investors sued the advisors.

By early 2006, the investors settled all claims with the advisors except those against William E. Bradley, a Louisiana attorney. The investors contended that Bradley was a member of the conspiracy and was paid $255,000 from money that the investors paid to the advisors' enterprise for its fraudulent advice. According to the court's findings of fact, Bradley was recruited by former defendant John B. Ohle III, of Bank One NA, to (1) fax an opinion letter to Jenkens & Gilchrist that Bradley did not prepare and (2) mail fraudulent invoices to Jenkens & Gilchrist for matters related to the investors. In total, Bradley billed $112,500 to Jenkens & Gilchrist, an amount that was dictated to him and did not reflect his usual billing rate.

Afterwards, Jenkens & Gilchrist wired $255,000 into Bradley's IOLTA bank account. Per Ohle's instructions, Bradley then wrote a $184,000 check to an unknown co-conspirator and wired $46,000 to Ohle. Bradley kept the remaining $25,000: he wrote three separate checks from his IOLTA account to himself in the amounts of $5,000, $15,000, and $5,000 respectively. Bradley had never spoken to the investors about anything, nor did he maintain a file containing any information regarding the investors. In fact, Bradley admitted that he knew little about the basis of the financial transactions and did not know the source of the funds deposited in his IOLTA account.[10]

The investors asserted claims against Bradley for breach of fiduciary duty, fraud, negligent misrepresentations, civil conspiracy, and RICO violations.[11] Specifically, the investors claimed that Bradley violated 18 U.S.C. § 1962(a), (b), (c), and (d). These RICO subsections state that:

(a) a person who has received income from a pattern of racketeering activity cannot invest that income in an enterprise;

(b) a person cannot acquire or maintain an interest in an enterprise through a pattern of racketeering;

(c) a person who is employed by or associated with an enterprise cannot conduct the affairs of the enterprise through a pattern of racketeering activity; and

(d) a person cannot conspire to violate subsections (a), (b), or (c).

Following a bench trial, the court concluded that Bradley qualified as a RICO person and that he and the other named defendants constituted an association-in-fact enterprise. Bradley's racketeering acts included numerous acts of mail and wire fraud. According to the court's conclusions of law, Bradley used the mails and telephones to fax the fraudulent opinion regarding the tax strategies and send various fraudulent invoices for services rendered in connection with the investors' matter. Additionally, Bradley received a wire transfer from Jenkens & Gilchrist for fraudulent fees he billed, and he wired some of this fraudulently-obtained money to Ohle and the JDC Group, Inc. The court concluded these predicate acts "had a common purpose of deriving exorbitant fees and deceiving [the investors] as to the legality of the tax strategies."[12] The court also determined the predicate acts posed a threat of continued criminal activity because others were solicited by various named defendants regarding participation in the tax strategies and Bradley had prior business dealings with Ohle which involved money being wired into Bradley's IOLTA account.

The investors were injured by Bradley's use of racketeering proceeds

To prove a violation of Section 1962(a), a plaintiff must establish (1) the existence of an enterprise, (2) a defendant's derivation of income from a pattern of racketing activity, and (3) the use of any part of that income in operating the enterprise. The court concluded that Bradley violated Section 1962(a) because he:

- "was recruited by Ohle to bill Jenkens & Gilchrist";
- "wrote an invoice to Jenkens & Gilchrist in the amount of $112,500.00 for less than ten hours of work on matters related to the [investors]";
- "derived income from the pattern of racketeering activity when he subsequently received $225,000.00 by wire from Jenkens & Gilchrist"; and
- "used part of this income to invest back into the enterprise when, at the behest of one of the other Defendants, he wired $46,000.00 from his IOLTA account to Ohle and he wrote a check in the amount of $184,000.00 to JDC Group, Inc."[13]

According to the court, the investors were injured by Bradley's "use or investment of racketeering proceeds into the RICO enterprise" as it "permitted the [advisors] to fraudulently obtain funds from the [investors] for work they did not do."[14] In short, the injury that flowed from Bradley's investment equaled $230,000.00, the amount that Bradley wired to Ohle and remitted by check to JDC Group, Inc.

No nexus existed between the investors' injuries and the claimed § 1962(b) violation

Next, the court quickly concluded that Bradley did not violate Section 1962(b). That subsection provides that "a person may not acquire or maintain an interest in an enterprise through a pattern of racketeering."[15] Here, the court found no causal connection between the investors' injuries and Bradley's acquisition or maintenance of an interest in the enterprise.[16]

The enterprise deceived the investors into participating in the tax strategy

Section 1962(c) "prohibits any person employed by or associated with any enterprise from participating in or conducting the affairs of that enterprise through a pattern of racketeering activity."[17] The court concluded that Bradley violated Section 1962(c) because he:

- "was a person employed or associated with the enterprise as he was solicited by Ohle, Bank One and/or Jenkens & Gilchrist";
- "faxed the opinion and billed Jenkens & Gilchrist for $112,500.00 for work on the [investors'] account that he knew was fraudulent since he estimated that it took less than ten hours to complete";

- "wir[ed] . . . money obtained through fraudulent fees"; and
- "caused the [investors] to be charged exorbitant fees and furthered the air of legitimacy of the tax strategies."[18]

Simply put, Bradley's predicate acts "permitted the enterprise to deceive the [investors] into participating in the tax strategy."[19] According to the court, the investors' injury included the tax assessments, fees, and penalties they were required to pay to the IRS, as well as their related legal fees and costs.

Bradley was part of a conspiracy to generate exorbitant fees

To prove a RICO conspiracy under Section 1962(d), a plaintiff must establish that (1) two or more people agreed to commit a particular substantive RICO offense and (2) the defendant knew of and agreed to the objective of the RICO offense. In this case, the investors alleged a violation of 18 U.S.C. § 1962(a), (b) and (c) as the substantive offenses. The court concluded that Bradley violated Section 1962(d) because he and the other named defendants agreed to make false representations to the investors in order to induce them into participating in tax strategies that the advisors knew or should have known were illegal. To this end, Bradley faxed the fraudulent opinion, over-billed the hours he expended, and wired money obtained through fraudulent fees. As a result of the advisors' conspiracy, the investors invested in the tax strategy and suffered losses of tax assessments, fees, penalties, and related legal fees and costs.[20]

Bradley's $25,000 translated to a $6,000,000 award for the investors

The court held that Bradley was liable to the investors for violations of 18 U.S.C. § 1962(a), (c) and (d), breach of fiduciary duty, negligent misrepresentation, fraud, and civil conspiracy. The court found that the investors were entitled to (1) $690,000 ($230,000 multiplied by 3), plus costs and reasonable attorneys' fees for Bradley's violation of Section 1962(a); (2) $6,432,600 ($2,144,200 multiplied by 3), plus costs and reasonable attorneys' fees for Bradley's violation of Sections 1962(c) and (d); or (3) $2,144,200 for Bradley's breach of fiduciary duty, negligent misrepresentation, fraud and civil conspiracy. The court stated the awards in the alternative because the case involved multiple theories of liability. In the end, the total amount recoverable by the investors was $6,432,000, plus reasonable attorneys' fees and costs.[21]

In recent years, there has been a great deal of concern among commentators and practitioners that the application of civil RICO has expanded well beyond its intended sphere. From the limited discussion of RICO's dozens of pleading and proof requirements, it is impossible to tell whether *Ducote Jax Holdings* is but the latest attempt to shoehorn an ordinary fraud and conspiracy case into the RICO framework.

Recent Opinions From the Fifth Circuit

As in the past years, we have categorized the reported opinions from the Fifth Circuit under the specific RICO elements to which those opinions provide further clarification because each element is a term of art that carries its own inherent requirements of particularity.[22] To this end, we examine those opinions addressing requisite injury under Section 1964 and then Section 1962 violations and their constituent elements.

Section 1964(c)—Injury to business or property by reason of prohibited conduct

Actual Injury

Economic consequences of personal injuries do not qualify as "injury to business or property." *Bradley v. Phillips Petroleum Corp.*, 527 F. Supp. 2d 625, 646 (S.D. Tex. 2007) (Atlas, J.) (granting defendants' motion to dismiss civil RICO claim).

Former domestic employees had standing to pursue their claims that oil and gas firms harbored and knowingly employed thousands of illegal workers in an illegal worker hiring scheme because the domestic employees were directly injured by the depressed wages. *Cunningham v. Offshore Specialty Fabrications, Inc.*, No. 5:04-CV-282, 2008 WL 276403, at *24 (E.D. Tex. Jan. 30, 2008) (Folsom, J.) (denying defendants' motion to dismiss civil RICO claim).

Proximate Cause/Causal Link

Reliance

When the underlying predicate act is that a competitor lured a plaintiff's customers away by a fraud aimed at its customers, the plaintiff must allege that its customers relied on the alleged misrepresentation. *Joe N. Pratt Ins. v. Doane*, No. V-07-07, 2008 WL 819011, at *7 (S.D. Tex. Mar. 20, 2008) (Rainey, J.) (granting defendants' motion to dismiss civil RICO claims).

Section 1962(c)—Conduct of an enterprise through a pattern of racketeering

Enterprise

A RICO enterprise cannot be a "pattern of racketeering activity" but must be an "entity separate and apart from the pattern of activity in which it engages." *In re McCann*, No. 06-20488, 2008 WL 638139, at *6 (5th Cir. Mar. 7, 2008) (declaring that district court did not err when it rejected the bankruptcy court's proposal to enter a RICO judgment in favor of the creditor).

Association-in-Fact Enterprise

Plaintiff failed to plead specific facts showing that the association-in-fact enterprise existed separately and apart from pattern of racketeering or that its members functioned as a continuing unit with a coherent decision making structure. *Clark v. Douglas*, No. 06-40364, 2008 WL 58774, at **4-5 (5th Cir. Jan. 4, 2008) (affirming district court's decision to grant defendants' motion to dismiss civil RICO claims).

Plaintiffs failed to allege that lenders did anything other than make loans that they knew or should have known were secured by inflated collateral values, as there was no allegation of a mechanism in place for controlling and directing the affairs of the lenders or that they were part of an association. *Gray v. Upchurch*, No. 05:05cv210-KS-MTP, 2007 WL 2258906, at **4-5 (S.D. Miss. Aug. 3, 2007) (Starrett, J.) (finding allegations of an enterprise consisting of the realtor, seller, appraiser, and attorney sufficient to withstand a Rule 12(b)(6) challenge since the complaint alleged that there was a continuing association among them that preceded and postdated the discrete act of selling the property in question).

To establish the existence of an association-in-fact enterprise, plaintiff must allege the association's organizational characteristics and specific facts showing that the association exists for purposes other than to commit the predicate offenses. *De Pacheco v. Martinez*, 515 F. Supp. 2d 773, 790 (S.D. Tex. 2007) (Tagle, J.) (granting defendants' motion to dismiss civil RICO claim).

Pattern

Plaintiffs failed to plead a pattern of mail fraud where there was no specific allegation that the documents notarized by defendants contained misrepresentations and the complaint simply alleged that defendants engaged in at least two instances of fraudulent use of the mails. *De Pacheco*, 515 F. Supp. 2d at 788-90.

Continuity

Plaintiff failed to plead closed or open-ended continuity where alleged pattern lasted only six months with no threat of future conduct. *Butler v. BancorpSouth Bank*, No. 3:05cv262-DPJ-JCS, 2007 WL 3237927, at **3-4 (S.D. Miss. Oct. 31, 2007) (Jordan, J.) (entering summary judgment in favor of defendants respecting civil RICO claims).

Plaintiffs' evidence failed to show that association-in-fact enterprise had a continuity of structure and a purpose shared by each member. *Do v. Pilgrim's Pride Corp*., 512 F. Supp. 2d 764, 768-70 (E.D. Tex. 2007) (Heartfield, J.) (entering summary judgment in favor of defendants respecting civil RICO claims).[23]

Section 1962(d)—Conspiracy to violate subsections (a), (b), or (c)

Plaintiffs failed to prove the elements of a RICO conspiracy because the evidence did not show that defendants knew the criminal nature of crane broker's activities and intentionally acted to assist in the underlying criminal activity. *Marlin v. Moody Nat'l Bank, N.A.*, 248 Fed. Appx. 534, 537-39 (5th Cir. Sept. 19, 2007) (affirming summary judgment entered in favor of defendants).

ENDNOTES

1 Mr. Gordon is a partner in the Dallas office of Gardere Wynne Sewell LLP. Samuel E. Joyner is an associate in the Dallas office of Gardere Wynne Sewell LLP. Mr. Gordon and Mr. Joyner wish to thank Lindsey Griffin for her capable research assistance. The views expressed in this article are the authors' alone and do not necessarily represent those of Gardere or its clients.

2 *Ducote Jax Holdings LLC v. Bradley*, No. 04-1943, 2007 WL 2008505, at *1 (E.D. La. July, 5, 2007)..

3 *Id*. at *1.

4 *Id*. at *2.

5 *Id*. at *1.

6 *Id*.

7 *Id*.

8 *Id*.

9 *Id*.

10 *Id*. at **2-4.

11 *Id*. at *2.

12 *Id*. at *5.

13 *Id*. at *6.

14 *Id*.

15 *Id*.

16 *Id*. at 7.

17 *Id*.

18 *Id*.

19 *Id*.

20 *Id*. at **7-8.

21 *Id*. at **12-13.

22 The individual elements of § 1962 are catalogued in "Parsing Civil RICO," which appeared in the Fall 2001 issue of this publication. It is available at www.texbuslit.org/members/newsletter.

23 It is noteworthy that Judge Thad Heartfield denied the defendants' motion to dismiss, concluding that the plaintiffs properly alleged the poultry processing plant and bank could have associated to defraud plaintiffs as to the proper value of their land by alleging how the association-in-fact enterprise existed apart from pattern of racketeering, how the enterprise operated, and how the enterprise will continue to operate in the future. *Do v. Pilgrim's Pride Corp*., No. 9:05CV238, 2006 WL 2290556, at **4-5 (E.D. Tex. Aug. 9, 2006).

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By Gregory S.C. Huffman

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