Chapter **7**

Criminal and Enforcement Litigation

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Chapter 7

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CRIMINAL LITIGATION

7.1 Securities Crime And Enforcement

7.1.1 Application Of The Misappropriation Theory Of Insider Trading To Tippee Liability After *O'Hagan*

***United States v. Falcone*, 257 F.3d 226 (2d Cir. 2001)**

United States v. Libera, 989 F.2d 596 (2d Cir. 1993), continues to provide the standard in the Second Circuit for evaluating tippee liability under the misappropriation theory of insider trading.

Joseph Falcone ("Falcone") was convicted of securities fraud in violation of section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, and conspiracy to commit securities fraud, in violation of 18 U.S.C. § 371. The district court denied Falcone's motion to set aside the verdict, holding that it was bound by the decision of the United States Court of Appeals for the Second Circuit in *Libera*. On similar facts, the *Libera* Court held that a tippee was liable for insider trading under the misappropriation theory where the tipper breached a duty owed to the owner of nonpublic information and the trading tippee knew that the tipper breached that duty. Under *Libera*, liability is not contingent on whether the tipper knows that the tippee is going to trade on the information, or whether the tipper himself traded on the inside information.

On appeal, Falcone argued that *Libera* was not controlling after the Supreme Court's decision in *United States v. O'Hagan*, 521 U.S. 642 (1997) because its facts would not satisfy the requirement, as interpreted by the *O'Hagan* Court, that the misappropriation be "in connection with" the purchase or sale of a security. Falcone argued in the alternative that even if *Libera* were controlling, the facts of his case were insufficient to establish liability under *Libera*. Rejecting both of Falcone's arguments, and affirming his conviction, the Court held that *Libera* was still controlling precedent in the Second Circuit with respect to tippee liability for insider trading.

Falcone's illegal trading was based upon information obtained from pre-release copies of the "Inside Wall Street" column of *Business Week* magazine. *Business Week* had a strict confidentiality policy with respect to the pre-release disclosure of the magazine and its contents because stocks that received a positive write-up in the column tended to increase in value after the column was released. The confidentiality policy applied to everyone involved in the magazine's production and distribution, including Hudson News, a magazine wholesaler. Hudson News also had its own policy prohibiting employees from removing any magazines it distributed, including *Business Week*, from its delivery department. In contravention of these policies, Falcone participated in a scheme whereby an employee of Hudson News would fax a copy of the "Inside Wall Street" column to a stockbroker prior to the magazine's weekly public release. The stockbroker traded on the information contained in the article and passed it to Falcone, who also traded on that information. The tipper did not trade on the information.

Falcone argued that his insider trading conviction could not be upheld because there was not a sufficient nexus between the misappropriation of information by the Hudson News employee and Falcone's securities trading to satisfy the "in connection with" requirement as analyzed in *O'Hagan.*[1] Although *O'Hagan* upheld the viability of the misappropriation theory, "it did not fully endorse the broad rationale th[e] [Second] Circuit provided . . . for why the deception of a source of confidential information was 'in connection with' the purchase or sale of a security." *United States v. Falcone*, 257 F.3d 226, 232 (2d Cir. 2001).[2] Rather, in *O'Hagan*, where the defendant attorney traded on the information he misappropriated, the Court held that the "in connection with" requirement was satisfied because the breach of duty and trading "coincided." That happened, according to the *O'Hagan* Court, because "'the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities.'" *Id.* at 232-33 (quoting *O'Hagan*, 521 U.S. at 656).

Seizing upon this rationale, Falcone argued that the requisite coincidence between the breach of duty and the securities trading mandated by *O'Hagan* was not present in his case. Rejecting this argument, the *Falcone* Court refused to read *O'Hagan* as *mandating* the existence of a trading tipper in order to establish the requisite nexus between the breach of duty and the securities trading:

> While, as the district court in the instant case pointed out, the coincidence of a securities transaction and breach of duty -- identified in *O'Hagan* as contributing to the satisfaction of the "in connection with" requirement -- is not

[1] Resolving an intercircuit split and upholding the validity of the misappropriation theory, the *O'Hagan* Court affirmed the conviction of an attorney who traded in the securities of the target of a tender offer based upon information he misappropriated from his law firm and its client (the tender offeror). The *O'Hagan* Court agreed "that section 10(b)'s deception requirement could be predicated on a fraud on the source of confidential information," holding that a violation of section 10(b) occurs pursuant to the misappropriation theory when a person "'misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.'" *United States v. Falcone*, 257 F.3d 226, 232 (2d Cir. 2001) (quoting *United States v. O'Hagan*, 521 U.S. 642, 652 (1997)). By way of contrast, under the traditional theory of insider trading liability -- pursuant to which a corporate insider trades in the securities of his own corporation -- "the duty of disclosure being breached is to persons with whom the insider is engaging in securities transactions, and the insider breaches that duty when he or she engages in the securities transaction without disclosure." *Id.* at 229.

[2] That rationale was set forth in *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), *aff'd in pertinent part by an equally divided court*, 484 U.S. 19 (1987), in which the Second Circuit upheld the convictions of a newspaper reporter, newspaper clerk and stockbroker for trading on information misappropriated from the *Wall Street Journal*. The *Carpenter* Court reasoned that the "in connection with" requirement was satisfied because "'those who purchased or sold securities without the misappropriated information would not have purchased or sold, at least at the transaction prices, had they had the benefit of the information,'" and because "'the misappropriated information . . . had no value whatsoever . . . except in connection with their subsequent purchase[s] [and sales] of securities.'" *Falcone*, 257 F.3d at 230-31 (quoting *Carpenter*, 791 F.2d at 1032-33 (internal quotations omitted)).

> present where, as here, the misappropriator tips the information to an outsider but does not trade or have others trade on his or her behalf, the Supreme Court in *O'Hagan* did not purport to set forth the sole combination of factors necessary to establish the requisite connection in all contexts.

Id. at 233 (footnote omitted).

Rather than looking to the existence of a trading tipper, the Court held that "*O'Hagan's* requirement that the misappropriated information ordinarily be valuable due to its utility in securities trading," would "be a more generally applicable factor in determining whether section 10(b)'s in connection with requirement is satisfied." *Id.* (citation and internal quotation marks omitted). The Court held further that such a requirement would be satisfied where, as here, "the misappropriated information is a magazine column that has a known effect on the prices of the securities of the companies it discusses." *Id.* at 234.

The Court thus concluded that "[a]pplication of *Libera* to the instant case is . . . not undermined by the lack of a trading tipper here, notwithstanding the intervening decision in *O'Hagan,*" and that *Libera* "continues to provide the relevant criteria by which to evaluate defendant's conviction." *Id.* at 233-34. The Court ultimately found that the facts were sufficient to support Falcone's conviction under *Libera*.

United States v. Kim, No. CR-01-0193, 2002 WL 75846 (N.D. Cal. Jan. 15, 2002), _amending and superseding_, 173 F. Supp.2d 1035 (N.D. Cal. 2001)

In a case demonstrating a limit to the common law misappropriation theory, the Northern District of California held that one club member did not commit insider trading by buying the securities of another club member's company -- based upon information provided by the other club member -- because the club members did not owe each other any legal duty of confidentiality. That is, there was no fiduciary duty, or similar relationship of trust and confidence, among the club members. The Court noted, however, that the trading at issue is now proscribed by Rule 10b5-2, 17 C.F.R. § 240.10b5-2, which was effective as of August 2000. That rule sets forth three non-exclusive instances giving rise to a legal duty of confidentiality for purposes of the misappropriation theory, remedying the apparent "loophole" in the case law as demonstrated by the instant case.

Keith Joon Kim ("Kim") was CEO of a food company and a member of the Young Presidents Organization ("YPO"), "a national organization of company presidents under 50 years old . . . organized into regional chapters, and further divided into small forums." *United States v. Kim*, No. CR-01-0193, 2002 WL 75846, at *1 (N.D. Cal. Jan. 15, 2002), *amending and superseding*, 173 F. Supp.2d 1035 (N.D. Cal. 2001). In March 1999, the Northern California forum held its annual retreat in Colorado. One of Kim's fellow forum members, the CEO of Meridian Data, Inc., informed a forum official that he could not attend the retreat because Meridian was in merger discussions, and authorized the official to convey this information to the other members of the forum on a confidential basis. The official conveyed this information to the other forum members, including Kim. Kim, in turn, disclosed this information to his business partner, brother and brother-in-law, and each purchased Meridian stock based upon the information. Thereafter, Meridian announced that it was being acquired by another company and its share price increased substantially. Kim was charged with securities fraud, wire fraud and making a false statement, and moved to dismiss the securities and wire fraud charges. The Court granted Kim's motion.

The Court recited at the outset that, pursuant to the standard set forth in *United States v. O'Hagan*, 521 U.S. 642 (1997), "a person commits fraud 'in connection with' a securities transaction . . . 'when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.'" *Kim*, 2002 WL 75846, at *2 (quoting *O'Hagan*, 521 U.S. at 652). In contrast to the traditional theory of insider trading, which "involves a breach of duty between a corporate insider and the corporation's shareholders, misappropriation involves a breach of duty between the owner of the confidential information and the individual entrusted with that information." *Id.* The Court thus framed the issue presented as "whether the relationship between defendant and the members of the . . . [f]orum is such that it gives rise to a *legal* duty of confidentiality, a violation of which can serve as the predicate for criminal liability under the misappropriation theory." *Id.* at *3.

Noting that, unlike the case before it, *O'Hagan* involved the breach of a classic fiduciary trust (attorney-client), the Court turned to the Second Circuit's decision in *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991), as the seminal case addressing the circumstances under which a relationship that is not a "hornbook" fiduciary relationship can nonetheless give rise to liability under the misappropriation theory. The Court recited that, under *Chestman*, "'a person violations Rule 10b-5 when he misappropriates material nonpublic information in breach of a fiduciary duty *or similar relationship of trust and confidence* and uses that information in a securities transaction.'" *Kim*, 2002 WL 75846, at *3 (quoting *Chestman*, 947 F.2d at 566) (alteration in original). Holding that "the primary essential characteristic of the fiduciary relation is some measure of superiority, dominance, or control," the Court further refined the issue before it as "whether the relationship between defendant and the CEO of Meridian and other members of the . . . [f]orum is best characterized as an equal relationship between peers or as a relationship involving a degree of dominance." *Id.* at *4. The Court held that there were three indicators of a relationship marked by dominance: (i) "disparate knowledge and expertise;" (ii) "a persuasive need to share confidential information;" and (iii) "a legal duty to render competent aid." *Id.* at *5.

As to the first factor, the Court held that the membership of Kim and the CEO of Meridian in the YPO "ensures similar levels of achievement, experience and expertise." *Id.* As to the second factor, the Court held that there was no need to disclose the fact of the merger discussions. To the contrary, the Court stated affirmatively that the CEO of Meridian should not have made this disclosure, further explaining that "the proposed extension of [the] misappropriation theory [to these facts] would have the practical [and deleterious] effect of encouraging the spread of confidential information more widely, thereby increasing the likelihood of abuse." *Id.* Finally, the Court held that there was no legal duty present, despite the written confidentiality agreement that all members of the YPO were required to sign as a condition of membership, because while "[t]h[at] agreement may memorialize a moral and ethical duty that members undertake, . . . it does not create a legal one." *Id.* at *6. The Court thus concluded that there was no "measure of superiority, dominance or control" between Kim, the CEO of Meridian, and the other members of the club, *id.*, that there thus was no relationship of trust and confidence similar to a fiduciary relationship, and that, therefore, there was no legal duty that could have been breached.[3]

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[3] The Court noted that this conclusion was logical because the breach of the duty allegedly owed here -- a duty to an insider of the company whose securities were traded -- is

Of import, the Court noted that the facts alleged would now constitute insider trading under Rule 10b5-2, which took effect on August 24, 2000, and which was not applicable to Kim's 1999 trading. Seemingly addressing the "loophole" in the case law, the rule "defines three non-exclusive circumstances under which a person has a duty of trust or confidence for purposes of the misappropriation theory of insider trading," imposing such duty whenever: (i) "a person agrees to maintain information in confidence;" (ii) "the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences;" or (iii) "a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling." *Kim*, 2002 WL 75846, at *7 (internal quotations omitted). The Court held that both the first and second scenarios would now prohibit Kim's conduct.

7.1.2 Compulsion Of Testimony By Regulatory Organization Does Not Violate Fifth Amendment Despite Assistance Provided By Unit Of Organization With Parallel Criminal Investigation

***D.L. Cromwell Investments, Inc., v. NASD Regulation, Inc.*, 132 F. Supp.2d 248 (S.D.N.Y. 2001), *aff'd*, No. 01-7301, 2002 WL 126587 (2d Cir. Feb. 1, 2002)**

Compulsion of testimony by NASD Regulation, Inc. ("Regulation") did not violate plaintiffs' Fifth Amendment right against self-incrimination where Regulation's actions were not "fairly attributable to" the government.

In late 1998, D.L. Cromwell Investments, Inc. ("Cromwell"), a member of the National Association of Securities Dealers ("NASD"), came under investigation by Regulation's Division of Enforcement ("DOE"). Shortly thereafter, the federal government began its own investigation of Cromwell with the assistance of the DOE's Criminal Assistance Prosecution Unit ("CPAG"). CPAG was "formed . . . within the DOE to provide assistance and advice to federal and state law enforcement authorities investigating securities matters," and "conduct[s] no investigations or other enforcement activities on behalf of Regulation." *D.L. Cromwell Invs., Inc. v. NASD Regulation, Inc.*, 132 F. Supp.2d 248, 249 (S.D.N.Y. 2001), *aff'd*, No. 01-7301, 2002 WL 126587 (2d Cir. Feb. 1, 2002). "[T]he professed policy of Regulation with respect to CPAG and the rest of the DOE [wa]s one of complete separation of activities." *Id.* The criminal and regulatory investigations of Cromwell ensued for the following two years, and the persons conducting those investigations exchanged certain information and documentation. This action was commenced in response to DOE demands for recorded interviews of Cromwell and four of its employees.

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traditionally redressed under the traditional theory of insider trading. However, because the government "[p]resumably . . . conclu[ded] that they [could] []not prove a mental state of the CEO of Meridian that would support tipper liability when he revealed the merger information," *United States v. Kim*, No. CR-01-0193, 2002 WL 75846, at *9 n. 3 (N.D. Cal. Jan. 15, 2002), *amending and superseding*, 173 F. Supp.2d 1035 (N.D. Cal. 2001), it instead "attempt[ed] to redeploy [the] misappropriation theory here to the rare case were [sic] the intentional disclosure of material, nonpublic information by an insider does not result in tipper-tippee liability." *Id.* at *6. The Court also dismissed the wire fraud count for lack of an underlying duty.

The individual plaintiffs sought to enjoin Regulation from compelling their testimony and from punishing them for asserting their Fifth Amendment rights. These plaintiffs argued that Regulation's attempt to compel their testimony violated their Fifth Amendment rights because Regulation "really" was acting as an agent of the government in seeking their testimony. All plaintiffs sought to enjoin Regulation from misusing federal grand jury materials in a non-governmental investigation, arguing that in the event the Court found that Regulation was not acting as an agent of the government, grand jury materials had been provided to Regulation in violation of Criminal Rule 6(e). After holding an evidentiary hearing on the motion, and consolidating that hearing with a trial on the merits, the Court denied plaintiffs' motion in its entirety.

The individual plaintiffs argued that DOE's demands were nothing more than an attempt by the government "to coerce them into surrendering their privileges against self-incrimination by threatening them with permanent banishment from the securities industry if they decline[d] to testify." *Id.* at 251. That is, plaintiffs argued, the government's conduct forced them into a "Hobson's choice": if they complied with DOE's demands, they risked incriminating themselves in the pending criminal investigation, but if they refused to comply, they risked being sanctioned by the NASD.

Noting that "[t]he Fifth Amendment prohibits only governmental action," and that "[t]he NASD and Regulation are private entities," the Court held at the outset that "even if the individual plaintiffs [we]re being compelled to give evidence against themselves by the threat of NASD sanctions, Regulation's actions raise no Fifth Amendment issue unless it fairly may be said that its actions are fairly attributable to the government." *Id.* at 252. This, the Court concluded, "requires that the government have 'exercised coercive power or . . . provided such significant encouragement, either overt or covert, that the choice must in law be deemed to be that of the' government or, at least, that 'the private entity has exercised powers that are traditionally the exclusive prerogative of the State.'" *Id.* (quoting *Blum v. Yaretsky*, 457 U.S. 991, 1004-05 (1982)) (internal quotations omitted).

Finding "no direct evidence of . . . governmental involvement," and noting that "all of the relevant Regulation personnel . . . flatly den[ied] that the . . . demands [we]re the product of any urging or suggestion by the United States Attorney's office or any other governmental agency," *id.*, the Court concluded that "there [wa]s no basis whatever for enjoining the . . . [DOE's] interviews." *Id.* at 253. In so holding, the Court rejected plaintiffs' argument that certain circumstances -- including certain contacts between and among the government, CPAG and DOE regarding the investigations -- mandated the conclusion that the DOE was acting as agent of the government:

> Regulation has submitted extensive proof that its regulatory investigation is being carried out by the DOE, that there is no connection between that investigation and the grand jury investigation, and that the CPAG personnel are . . . "walled off" from the other activities of the DOE. The Court credits that evidence and finds that the . . . demands are not the product of any government coercion, suggestion or other action.

Id.

The Court also rejected plaintiffs' alternative argument that, in the event that Regulation was not acting as an agent of the government, then grand jury materials improperly were provided to Regulation. The Court held that "there simply is no credible proof that any

materials subject to Rule 6(e) have been disclosed to or used by Regulation personnel who have not been authorized by court order to have them." *Id.* at 254.

Despite its ruling on these facts, the Court did caution that "Regulation may wish to give careful attention to its arrangements concerning assistance to criminal investigations and to the relationships, both physical and administrative, between CPAG and the DOE."[4] *Id.* In the Court's view, "the physical circumstances and administrative arrangements" at DOE were not consistent with "the professed policy . . . of complete separation of activities" between "CPAG and the rest of the DOE ." *Id.* at 249.

7.2 Mail Fraud

7.2.1 Fourth Circuit Adopts "Reasonably Foreseeable Harm" Test For Criminal Liability Under The Honest Services Doctrine

***United States v. Vinyard*, 266 F.3d 320 (4th Cir. 2001)**

Recognizing a split in the circuits, the Fourth Circuit adopted the "reasonably foreseeable harm" test for criminal liability under the deprivation of honest services doctrine of the federal mail fraud statute. The Court held further that this test does not require proof of actual economic harm.

Michael Vinyard was convicted of mail fraud and money laundering and challenged his conviction and sentence. One of the grounds upon which he challenged his conviction was his argument that the federal mail fraud statute was not applicable "because he neither intended to cause economic harm, nor caused actual economic harm, to [his brother's employer]." *United States v. Vinyard*, 266 F.3d 320, 324 (4th Cir. 2001). Although Michael Vinyard styled this portion of his appeal as a challenge to the denial of his motion to dismiss the mail fraud charges, the Court also analyzed the appeal (and deemed it more appropriately styled) as a challenge to the denial of his motion for judgment of acquittal. The Court affirmed the denial of both motions.

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[4] The Court described these physical and administrative arrangements as follows:

The head of the CPAG unit reports to a superior who supervises the DOE's investigatory functions as well. He shares a secretary with another lawyer who works on DOE private investigations. The CPAG examiner and investigator each have office cubicles in six-cubicle clusters, the other five occupants of each of which work on DOE investigations. CPAG shares telephone, fax and computer systems with the DOE. It has no locked file cabinets save a file drawer in the desk of the CPAG attorney. In short, the physical circumstances of CPAG and the DOE provide no assurance that confidential material in the hands of CPAG does not come to the attention of DOE investigators or that information concerning DOE investigations does not come to the attention of CPAG personnel. One is left to trust the good faith and judgment of the personnel involved.

D.L. Cromwell Invs., Inc. v. NASD Regulation, Inc., 132 F. Supp.2d 248, 249 (S.D.N.Y. 2001), *aff'd*, No. 01-7301, 2002 WL 126587 (2d Cir. Feb. 1, 2002).

James Vinyard, Michael's brother, was employed by Sonoco Products Corporation ("Sonoco"), which manufactured, among other things, plastic grocery bags. A decision was made at Sonoco to use recycled materials to make its grocery bags, and Sonoco authorized James Vinyard to hire an independent broker to find suppliers of these materials and to negotiate deals for Sonoco. Rather than hire the independent broker as instructed, James, together with Michael (then a practicing attorney), created Charles Stewart Enterprises ("CSE") and presented CSE to Sonoco and the recycled material suppliers as an independent broker. James managed the operations of CSE while Michael took care of the administrative matters from his law office. CSE purchased recycled materials from the brokers, resold them to Sonoco and earned a commission on each sale. The Court described the scheme as follows:

> Under James's direction, CSE presented itself to Sonoco and plastic vendors as an independent broker . . . Sonoco was led to believe that Charles Stewart was an actual person at CSE and also that CSE was a legitimate broker of recycled . . . [materials] that could provide such . . . [materials] at the lowest possible price.
>
> . . . .
>
> In carrying out the fraud scheme, James consistently misrepresented the relationship between CSE and Sonoco. He advised outside vendors that CSE had been established to protect Sonoco's confidentiality, with Sonoco's full knowledge. Similarly, CSE employees . . . were told that Sonoco was aware of James's involvement in CSE, but they were warned not to disclose the Vinyard name to others.

Id. at 323. James Vinyard pleaded guilty and cooperated with the government. Michael Vinyard was convicted of multiple counts of mail fraud, in violation of 18 U.S.C. §§ 1341 and 1346, and money laundering.

The mail fraud counts alleged in pertinent part that the scheme deprived Sonoco of the honest services of James Vinyard.[5] On appeal, Michael Vinyard argued that his mail fraud conviction could not stand because "actual economic harm to the employer is a necessary element of this crime in the private employment context," and Michael neither intended to cause, nor caused, any economic harm to Sonoco. *Id.* at 325.

Analyzing the denial of Michael Vinyard's motion for judgment of acquittal, the Court recognized that it had not yet "addressed the reach of the honest services doctrine in the private employment context." *Id.* at 327.[6] The Court also recognized that other circuits were

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[5] 18 U.S.C. § 1346 defines "scheme or artifice to defraud" for purposes of the primary mail fraud statute to include "a scheme or artifice to deprive another of the intangible right of honest services."

[6] The Court agreed, as a preliminary matter, that the honest services doctrine applied in the private employment context, noting that "[a]lthough the honest services theory of mail fraud is directed primarily at the deterrence and punishment of corruption among public officials, the courts have consistently recognized the statute's province to encompass

in disagreement on the applicable standard; some utilized a "reasonably foreseeable harm" test, and others utilized a "materiality test":

> On the one hand, several circuits have held that the Government must prove that the employee intended to breach a fiduciary duty, and that the employee foresaw or reasonably should have foreseen that his employer might suffer an economic harm as a result of the breach (the "reasonably foreseeable harm test"). On the other hand, some circuits have construed the honest services doctrine merely to require a showing that the employee possessed a fraudulent intent and that the misrepresentation at issue was material. (the "materiality test").

Id. at 327 (citations and internal quotations omitted). Recognizing that "[c]ourts that prefer the materiality test have [broadly] defined materiality as any misrepresentation that has the natural tendency to influence or is capable of influencing the employer to change his behavior," the Court stated that the materiality test improperly focuses on employer response rather than employee intent and "potentially criminalize[s] any breach of a duty of loyalty in the private employment context." *Id.* at 328. The Court thus adopted the reasonably foreseeable harm test because it "keeps the focus of the analysis on employee intent rather than on employer response," and "does not extend . . . liability to circumstances in which employers change their business practices to avoid the mere appearance of impropriety." *Id.*

Having adopted the reasonably foreseeable harm test, the Court rejected Vinyard's contention that his conviction could not stand because he did not economically harm, or intend to economically harm, Sonoco. As the Court stated, "[t]he reasonably foreseeable harm test neither requires an actual economic loss nor an intent to economically harm the employer." *Id.* at 329. Rather, "the employee need only intend to breach his fiduciary duty and reasonably foresee that the breach would create an identifiable economic risk for the employer." *Id.* (internal quotations omitted). Applying this standard to the facts at bar, the Court concluded that the scheme "deprived Sonoco of the chance to consider a variety of brokers and to search for the best possible price," and that, therefore, it was reasonably foreseeable at the time of the fraud that CSE "may [not] have provided the optimal broker service to Sonoco." *Id.* at 330. The Court thus affirmed the denial of Michael Vinyard's motion for judgment of acquittal.[7]

7.3 Racketeer Influenced And Corrupt Organizations Act

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dishonest acts perpetrated in private commercial settings." *United States v. Vinyard*, 266 F.3d 320, 326 (4th Cir. 2001).

[7] The Court also affirmed the denial of Michael Vinyard's motion to dismiss the indictment, noting that all of the essential elements of the mail fraud offense were properly plead.

7.3.1 Supreme Court Holds That A Corporate Employee Acting Within The Scope Of His Employment May Be Liable Under RICO

***Cedric Kushner Promotions, Ltd. v. King*, 533 U.S. 158, 121 S.Ct. 2087 (2001)**

Resolving a conflict among the circuits, the United States Supreme Court held in a civil matter that a corporate employee could be liable as a "person" under the Racketeer Influenced and Corrupt Organization Act, 18 U.S.C. § 1961, et seq. ("RICO") for actions taken within the scope of his corporate authority where the corporate employer was alleged to be the RICO "enterprise." The Court thus explicitly rejected the Second Circuit's rule that a corporate employee acting within the scope of his authority was not distinct from his corporate employer, as is required to establish RICO liability.

Cedric Kushner Promotions, Ltd. ("Kushner"), a boxing promoter, sued Don King ("King"), another boxing promoter, alleging that King operated Don King Productions ("King Productions"), of which King was the president and sole shareholder, as an unlawful RICO enterprise. Kushner did not dispute that the allegedly violative conduct occurred while King was acting within the scope of his authority as an employee of King Productions. King moved to dismiss the complaint, and his motion was granted by the district court. The district court's decision was affirmed by the United States Court of Appeals for the Second Circuit. The Second Circuit held that, because King was an employee acting within the scope of his corporate authority, he was, "in a legal sense . . . part of, not separate from, the corporation [and, thus,] [t]here was no 'person,' distinct from the 'enterprise,' who improperly conducted the 'enterprise's affairs.'" *Cedric Kushner Promotions, Ltd. v. King,* 533 U.S. 158, 121 S.Ct. 2087, 2090 (2001). The Supreme Court reversed, specifically rejecting the Second Circuit's interpretation of RICO's distinction requirement.

The Supreme Court agreed with the Second Circuit's preliminary holding that a RICO claim requires proof of two entities, a "person" and an "enterprise," as well as proof that there is "some distinctness" between them. That is, the enterprise cannot "simply [be] the . . . 'person' referred to by a different name." *Id.* However, the Court rejected the Second Circuit's holding that this requirement is not met where a corporate employee (alleged to be the RICO "person") runs a corporation as a racketeering enterprise while acting within the scope of his authority.[8] To the contrary, the Court held that the fact that the employee is legally distinct from the corporation is sufficient to satisfy RICO's distinction requirement, and noted that there was "nothing in the statute that requires more 'separateness' than that." *Cedric Kushner,* 533 U.S. 158, 121 S.Ct. at 2091. The Court thus concluded that "the need for two distinct entities is satisfied, hence, the RICO provision . . . applies when a corporate employee unlawfully conducts the affairs of the corporation of which he is the sole owner –

[8] The Court refused to address on their merits the prior Second Circuit cases setting forth this holding. The Court did distinguish those cases, however, as involving allegations regarding RICO "persons" and "enterprises" different from those at issue in *Cedric Kushner*. For example, unlike *Cedric Kushner*, in which a corporate employee was alleged to be the RICO "person" and the corporate employer was alleged to be the "enterprise," in *Riverwoods Chappaqua Corp. v. Marine Midland Bank, N.A.*, 30 F.3d 339 (2d Cir. 1994), the corporation was alleged to be the RICO "person" and the corporation, together with its employees and agents, were alleged to be the RICO "enterprise."

whether he conducts those affairs within the scope, or beyond the scope, of corporate authority." *Id.* at 2092.

The Court noted that its interpretation was supported both by the language and purpose of the RICO statute. As to the former, the Court held that:

> Linguistically speaking, an employee who conducts the affairs of a corporation through illegal acts comes within the terms of a statute that forbids any "person" unlawfully to conduct an "enterprise," . . . [a]nd, linguistically speaking, the employee and the corporation are different "persons," even where the employee is the corporation's sole owner. After all, incorporation's basic purpose is to create a distinct legal entity, with legal rights, obligations, powers, and privileges different from those of the natural individuals who created it, who own it, or whom it employs.

Id. at 2091. The Court also held that the application of the RICO statute to a corporate employee acting within the scope of his authority was "consistent with the statute's basic purposes . . . [to] protect[] a legitimate enterprise from those who would use unlawful acts to victimize it, and also [to] protect[] the public from those who would unlawfully use an enterprise (whether legitimate or illegitimate) as a vehicle through which unlawful . . . activity is committed." *Id.* at 2091-92 (internal citations and quotations omitted). Similarly, the Court held that the Second Circuit's interpretation was "inconsistent with a basic statutory purpose" because "[i]t would immunize from RICO liability many of those at whom this Court has said RICO directly aims – *e.g.*, high-ranking individuals in an illegitimate criminal enterprise, who, seeking to further the purposes of that enterprise, act within the scope of their authority." *Id.* at 2092.

Finally, the Court held that nothing in the statute's history requires a different interpretation. Noting that RICO's statutory history "refers to [among other things] the need to protect the public from those who would run organization[s] in a manner detrimental to the public interest," the Court concluded that this purpose was furthered by "the legal principle . . . that in [the] present circumstances the statute requires no more than the formal legal distinction between person and enterprise (namely, incorporation) that is present here." *Id.* (internal citations and quotations omitted).

7.3.2 First Circuit Holds That Jury Instruction Defining "Enterprise" Does Not Require Finding Of An "Ascertainable Structure"

***United States v. Patrick*, 248 F.3d 11 (1st Cir.), *cert. denied sub nom.*, *Arthur v. United States*, 122 S.Ct. 620 (2001)**

Defendants were convicted of RICO violations and other crimes arising out of their membership in a gang that distributed crack and were sentenced to life imprisonment. Defendants appealed their convictions and sentences on many grounds, including the district court's refusal to instruct the jury that an enterprise must have a "structure for the making of decisions." *United States v. Patrick*, 248 F.3d 11, 18 (1st Cir.), *cert. denied sub nom.*, *Arthur v. United States*, 122 S.Ct. 620 (2001). The United States Court of Appeals for the First Circuit affirmed defendants' conviction and sentence, explicitly refusing to adopt defendants' proposed jury instruction requirement.

The district court instructed, in pertinent part, that an enterprise:

> includes any individual, partnership, corporation, association or other legal entity, and any group of individuals associated in fact although not a legal entity. An enterprise may be a formal or an informal organization of individuals so long as they have associated together for a common purpose . . . To find that an association in fact existed, you must find that the alleged enterprise had an ongoing organization, formal or informal, and that its various associates functioned as a continuing unit for a common purpose. This means that although individuals may come and go, the enterprise must continue in an essentially unchanged form during substantially the entire period alleged in the indictment. Note that the enterprise element is different from the racketeering activity element. Although the proof to establish these elements may overlap, proof of one does not necessarily establish the other. Rather, the enterprise must be an entity separate and apart from the pattern of racketeering activity in which it engages.

Id. at 17. The district court refused to give the additional instruction, as requested by defendants, that "[a]t a minimum, the enterprise must exhibit some sort of structure for the making of decisions, whether it be hierarchical or consensual." *Id.* at 18. Citing to decisions of other circuit courts, defendants asserted that an explicit "ascertainable structure" jury instruction was required for criminal RICO charges. Defendants referred to this instruction as the "*Bledsoe* test" pursuant to the Eight Circuit's decision in *United States v. Bledsoe*, 674 F.2d 647 (8th Cir. 1982).

Noting that "the district court took its instruction almost directly from the language of the Supreme Court's decision in *United States v. Turkette*, 452 U.S. 576, 101 S.Ct. 2524, 69 L.Ed.2d 246 (1981)," the Court held that "no more was needed to define the term 'enterprise' for the jury" and "explicitly reject[ed] the *Bledsoe* test as an additional requirement beyond the *Turkette* instruction." *Patrick*, 248 F.3d at 18. Rather, the Court held that "[t]he important concept underlying Bledsoe" -- the requirement "that the government . . . prove both an enterprise and a pattern of racketeering activity" -- was reflected in the district court's instruction. *Id.* (internal quotation marks omitted). Finally, the Court stated that the *Bledsoe* instruction could be misleading because "criminal enterprises . . . may not observe the niceties of legitimate organizational structures." *Id.* at 19 (internal citations omitted).

7.4 Privilege And Evidentiary Issues

7.4.1 Corporation Can Waive Privilege For Communications Between Corporate Officer And Corporation's Attorney Made Both In Officer's Personal And Corporate Capacity

***In re Grand Jury Subpoena*, 274 F.3d 563 (1st Cir. 2001)**

An officer may assert a personal privilege, over the company's waiver, with respect to his communications with the company's attorney only where those communications were not

made in any way in his "corporate capacity" – *i.e.*, the communications must not concern the company's rights and responsibilities.

Former officers and attorney of a corporation (collectively, the "intervenors") moved to quash a subpoena duces tecum issued by a federal grand jury to the company's parent company (the "parent"), claiming that the records sought reflected privileged communications between the former officers and the attorney. Affirming the district court's denial of the intervenors' motion to quash, the United States Court of Appeals for the First Circuit held that a company "may unilaterally waive the attorney-client privilege with respect to any communications made by a corporate officer is his corporate capacity." *In re Grand Jury Subpoena*, 274 F.3d 563, 573 (1st Cir. 2001). While a personal attorney-client relationship may exist between a corporate officer and the company's attorney, their communications cannot be "jointly" privileged as to both the officer and the company such that the consent of both would be necessary to waive the privilege.

The company pled guilty to charges of conspiracy to defraud the IRS and agreed to cooperate with the government's ongoing investigation. As part of its cooperation, the company waived all applicable attorney-client and work product privileges. Thereafter, the government subpoenaed the parent seeking materials related to a purported scheme in which the company would overcharge certain conspiring customers and "refund" the overage through payments made directly to the principals of those customers.[9] The responsive materials included transcripts of interviews with employees of the company (including the intervening former officers) and the lawyer's summaries of the company's internal investigation of the purported scheme. Like its cooperating subsidiary, the parent waived all privileges relating to those records.

The intervenors claimed that the subpoenaed materials were "jointly" privileged pursuant to an oral joint defense agreement between the officers and the company and, thus, "could not be released without unanimous consent." *Id.* at 569. The intervenors claimed further that because the attorney previously represented both the company and the former officers with respect to the ongoing grand jury investigation, the terms of the oral joint defense agreement applied to the grand jury subpoena.

While recognizing "[t]he default assumption . . . that the attorney only represents the corporate entity, not the individuals within the corporate sphere," *id.* at 571, the Court agreed as a preliminary matter that the lawyer could have represented both the former officers and the company with respect to the grand jury investigation.[10] However, the Court specified that, in that instance, the "attorney-client relationship [with the former officers] would extend only to those communications which involved . . . [the former officers'] *individual rights and responsibilities* arising out of their actions as officers of the corporation." *Id.* at 572 (emphasis added). As such, the Court held that the officers could assert an individual privilege with

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[9] Although the government's investigation concerned activity that occurred at the company prior to its acquisition by the parent, the subpoena was served after the acquisition, when all of the company's records were in the possession of counsel for the parent.

[10] The Court rejected the government's argument that there could be no individual representation by the company's attorney regarding all matters that involve the company.

respect to their communications with the company's attorney "only to the extent that . . . [they] are separable from those made in . . . [the officers'] corporate capacity." *Id.* at 568.

Applying these principles, the Court noted that the intervenors did not point to any communications that concerned *only* the officers' individual rights and responsibilities. To the contrary, the officers claimed individual privileges with respect to communications that were made at least in part in their "corporate capacity" – *i.e.*, "in their capacities as corporate officers and corporate counsel, respectively, anent matters of corporate concern." *Id.* at 572. As to these communications, the Court held that the officers' privilege claim could not overcome the company's waiver:

> [W]e hold that a corporation may unilaterally waive the attorney-client privilege with respect to any communications made by a corporate officer in his corporate capacity, notwithstanding the existence of an individual attorney-client relationship between him and the corporation's counsel.
>
> . . . .
>
> On this view, it follows that . . . [the former officers] may only assert an individual privilege to the extent that communications regarding individual acts and liabilities are segregable from discussions about the corporation.

Id. at 573.[11] The Court thus rejected the intervenors' argument that communications between corporate officers and the corporation's attorney that related *both* to the corporation's rights and responsibilities, and to the officers' individual rights and responsibilities, should "be treated as jointly privileged such that the consent of all parties would be required to waive the privilege." *Id.* at 572. To permit such a joint privilege, the Court stated, "would unduly broaden the attorney-client privilege by allowing parties outside a given attorney-client relationship to prevent disclosure of statements made by the client." *Id.* The Court also rejected the intervenors' argument that the purported joint defense agreement mandated a different result. Citing an analogous decision by the Fifth Circuit, the Court held that where, as here, the parties to the agreement "were not independent actors, but, rather, corporate officers who owed a fiduciary duty to the corporation," the corporation could unilaterally waive the attorney-client privilege. *Id.* at 573.[12]

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[11] The Court reached a similar conclusion with respect to the intervenors' assertion of the work product privilege, holding that while the former officers "may, at least in theory, invoke the work product privilege as to work done exclusively for . . . [them] as individuals," the officers "effectively conceded that the work was performed, at least in part, for the corporation," and, therefore, neither the joint defense agreement nor anything else prevented the company from unilaterally waiving the privilege. *Id.* at 574.

[12] The Court also noted in this regard that parties to joint defense agreements remain free to disclose their own privileged communications, that protections afforded by joint defense agreements do not apply in subsequent litigation between the parties, that there was a split in the courts regarding the issue of whether one party to a joint defense agreement could prevent a former party from testifying against it in a criminal prosecution and that, in

Finally, the Court also held that the intervenors' motion to quash was properly denied for failure to produce a privilege log because "[a] party that fails to submit a privilege log is deemed to waive the underlying privilege claim." *Id.* at 576. The Court rejected intervenors' argument that they were prevented from preparing a privilege log because the district court refused to hold an evidentiary hearing, noting that the attorney had possession of the subpoenaed materials prior to the acquisition and thus had some knowledge of the nature of the materials. The Court held that the intervenors were required "to do the best that [t]he[y] reasonably . . . [could] to describe the materials to which . . . [their] claim adhere[d]." *Id.*

7.4.2 Admission Of Nontestifying Employee's Out-Of-Court Statements Against Co-Defendant Employer Does Not Violate Employer's Sixth Amendment Right To Confrontation

***United States v. Photogrammetric Data Services, Inc.*, 259 F.3d 229 (4th Cir. 2001)**

Admission of nontestifying employee's out-of-court statements against his co-defendant employer did not violate the employer's Sixth Amendment right to confrontation where the employee's statements were self-inculpatory and the employee did not attempt to shift blame off himself.

Appellants Photogrammetric Data Services, Inc. ("PDS") and David G. Webb ("Webb") were convicted of mail fraud and highway project fraud, and appealed their convictions and sentences. Among other grounds for appeal, PDS challenged the admission of incriminating statements made by Webb, who did not testify at trial, alleging that their admission violated PDS's Sixth Amendment right to confrontation. The United States Court of Appeals for the Fourth Circuit affirmed the district court's decision admitting Webb's statements. The Court held that because the statements were self-inculpatory, rather than self-exculpatory, they possessed the "particularized guarantees of trustworthiness" sufficient to satisfy the demands of the Sixth Amendment.

From 1994 through 1999 PDS created topographic maps as a subcontractor for firms that performed engineering work for the Virginia Department of Transportation ("VDOT") in connection with highway construction. During a significant portion of this time period, Webb was the photogram manager at PDS and prepared PDS's bills for the work it performed on the VDOT jobs. Webb continued PDS's long running practice of "padding" the bills -- *i.e.*, charging for hours that were not worked by PDS employees.

In 1997, a PDS employee approached the government with information about the over billing scheme, and agreed to act as an informant for the government. Webb subsequently made incriminating statements to the informant about the over billing practices. These statements were recorded by the informant. In January 1999, law enforcement agents interviewed Webb at his home, during which Webb admitted PDS's over billing practices and his participation therein. Although Webb did not testify at trial, the government offered, and the district court admitted, the incriminating statements he made to the informant and to the law enforcement agents. The district court admitted Webb's statements pursuant to Rule 801(d)(2)(D) of the Federal Rules of Evidence, and held further that their admission did not

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any event, the joint defense agreement alleged to exist here would be null and void because it was allegedly entered into at a time when there was no actual or potential litigation in sight.

violate PDS's Sixth Amendment rights. Webb and PDS were convicted of mail and highway project fraud in violation of 18 U.S.C. §§ 1341 and 1020, respectively, in connection with the overbilling scheme. On appeal, PDS challenged, among other things, the admission of Webb's incriminating statements as violative of PDS's Sixth Amendment right to confrontation.

The Court held that admission of Webb's statements did not violate PDS's right, as guaranteed by the Sixth Amendment, to confront the witnesses testifying against it.[13] Noting that the Confrontation Clause "reflects a preference for face-to-face confrontation at trial," the Court held, however, that it "does not prohibit the introduction of hearsay statements of an unavailable declarant which are marked with such trustworthiness that there is no material departure from the reason of the general rule." *United States v. Photogrammetric Data Servs., Inc.,* 259 F.3d 229, 243 (4th Cir. 2001) (internal quotations omitted). Thus, "a hearsay statement is admissible and does not violate the Confrontation Clause where . . . the statement bears sufficient indicia of reliability in that it falls within a firmly rooted hearsay exception, or has particularized guarantees of trustworthiness." *Id.* (internal quotations omitted).

The Court noted as a preliminary matter that statements by an employee against his employer concerning activities which the employee was hired to perform are inherently reliable. The Court noted further that such reliability is augmented when the employee's statements are self-inculpatory. Applying these principles, the Court held that because Webb admitted his own culpable conduct -- *i.e.*, while incriminating PDS, Webb also incriminated himself -- his statements contained particularized guarantees of trustworthiness and, as such, their admission did not violate the Confrontation Clause.[14]

> The inherent reliability and reasonableness of admitting such statements as evidence against the employer is even more compelling where, as here, the statement is inculpatory of the employee and, thereby, his employer, but is not exculpatory of the employee. Webb's statements admitting that he inflated the VDOT invoices were genuinely self-inculpatory and, while also inculpatory of PDS, the statements in no way attempted to shift blame to another or curry favor at the expense of others.

Id. at 245-46.

The Court thus rejected PDS's argument that Webb's statements were unreliable because Webb was PDS's accomplice. While noting the general rule "that an accomplice's confession that incriminates a defendant is presumptively unreliable," the Court held that that presumption is rebutted where, as here, the accomplice's confession is self-inculpatory "rather than an attempt to shift blame or curry favor." *Id.* at 244-45. Finally, the Court also rejected

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[13] Noting PDS's seeming agreement on point, the Court held as a preliminary matter that Webb's statements were properly admitted against PDS under Fed. R. Evid. 801(d)(2)(D) -- which provides that a statement offered against a party is not hearsay if it is made "by the party's agent or servant concerning a matter within the scope of the agency or employment, . . . during the existence of the relationship" -- because they "concerned Webb's billing practices and procedures at PDS while he was employed as the manager of the photogram department." *United States v. Photogrammetric Data Servs., Inc.,* 259 F.3d 229, 243 (4th Cir. 2001).

[14] In light of this decision, the Court held that it did not need to decide whether Webb's statements fell within a firmly rooted hearsay exception.

PDS's argument that the presumption of unreliability could not be rebutted because Webb's statements were made to law enforcement agents and their informant, refusing to adopt PDS's proposed rule barring admission of "an accomplice's hearsay statement . . . whenever the government has been involved in the production of the statement." *Id.*

7.5 United States Sentencing Guidelines

7.5.1 Amendments To The Sentencing Guidelines: Select Provisions Of The "Economic Crime Package"

Amendments to the United States Sentencing Guidelines -- including certain changes referred to as the "Economic Crime Package" -- took effect on November 1, 2001. Highlights of the Economic Crime Package include:

- Consolidation of the guidelines for theft (previously §2B1.1), property destruction (previously §2B1.3) and fraud (previously §2F1.1) into a single guideline for theft, property destruction and fraud offenses (new §2B1.1). The consolidated guideline retains the base offense level from the previous fraud guideline (which is higher than the base offense levels found in the previous theft and property destruction guidelines) and continues to include a loss table (revised as described below) for calculating increases to the base offense level based upon the amount of loss – *i.e.*, the greater the loss caused by defendant's conduct, the greater the increase in offense level and, therefore, the greater the punishment. The consolidated guideline continues to include a list of additional specific offense characteristics that, if applicable, require a further increase to the base offense level.

- Elimination of the more than minimal planning enhancement for the consolidated theft, property destruction and fraud guideline.

- A revised definition of loss for the consolidated theft, property destruction and fraud guideline. The new definition continues to define "loss" as the greater of the actual or intended loss. "Actual loss" is defined as the "reasonably foreseeable pecuniary harm" resulting from the offense, which in turn is defined as the "pecuniary harm that the defendant knew or, under the circumstances, reasonably should have known, was a potential result of the offense." Emotional distress, harm to reputation and other "non-economic harm" are specifically excluded from the definition of pecuniary harm. "Intended loss" is defined to include unlikely or impossible losses. FEDERAL SENTENCING GUIDELINES MANUAL §2B1.1, Application Note 2(A) (2001).

- A revised loss table for the newly consolidated theft, property destruction and fraud guideline (§2B1.1). The revised table provides for increases to the offense level in two-level increments, thereby increasing the loss range represented by each increment and reducing the need for fact-finding. The penalties for moderate and high loss amounts also have been increased significantly. The tax table (§2T4.1) was revised similarly.

7.5.2 Impact Of The Organizational Sentencing Guidelines On Director Liability: The Need For Effective Information And Reporting Systems In The Wake Of *Caremark*

In *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), the Delaware Court of Chancery held that a corporate director's duty of care included "a duty to attempt in good faith to assure that a corporate information and reporting system" was in place within the corporation and "that failure to do so . . . may . . . render a director liable for losses caused by non-compliance with applicable legal standards." *Id.* at 970. The *Caremark* Court explicitly recognized the impact of the organizational sentencing guidelines on director liability, stating that because they "offer powerful incentives for corporations today to have in place compliance programs to detect violations of law, promptly to report violations to appropriate public officials when discovered, and to take prompt, voluntary remedial efforts," *id.* at 969, "[a]ny rational person attempting in good faith to meet an organizational governance responsibility would be bound to take into account th[e] [organizational guidelines] . . . and the enhanced penalties and the opportunities for reduced sanctions that it offers." *Id.* at 970. This is equally true today.

***Dellastatious v. Williams*, 242 F.3d 191 (4th Cir. 2001)**

Corporate directors were not liable as "control persons" for alleged securities fraud where they acted in good faith reliance on a corporate decision-making process.

LaserVision Technologies, Inc. ("LaserVision") developed a camera technology for creating souvenirs at sports events. In 1997, as part of its plan to bring its product to market, LaserVision formed SurroundVision Advanced Imaging, LLC ("SAIL") to finance the marketing of the product. LaserVision was SAIL's corporate parent. Donald Williams ("Williams") served as a director of LaserVision and manager of SAIL. Raymond Kelly ("Kelly") served only as a director of LaserVision.

Seeking to raise capital for their business venture, certain officers of SAIL, along with LaserVision's attorney, began drafting an offering memorandum for use with potential investors. At some point thereafter, a draft of this document was reviewed by a certain director of LaserVision who previously had worked as a securities lawyer at the SEC. LaserVision's board was informed that his comments were "technical in nature" and that the memorandum would be revised accordingly. The offering memorandum subsequently was revised based upon his comments. In November 1997, SAIL sent the offering memorandum -- which incorporated the changes per the LaserVision director's comments (the "November Offering Memorandum") -- to Richmond Dellastatious ("Dellastatious"). Based at least in part upon the November Offering Memorandum, Dellastatious invested over $250,000 in SAIL. The offering memorandum was revised twice thereafter so that SAIL could raise additional equity, and the final revision was completed and mailed to Dellastatious in March 1998. SAIL discontinued operations shortly thereafter, however, rendering Dellastatious' entire investment worthless.

Dellastatious sued SAIL, three of SAIL's officers, LaserVision, Williams and Kelly claiming that the November Offering Memorandum was materially misleading in numerous respects. Dellastatious claimed that Williams and Kelly were liable as "control persons" pursuant to Section 20 of the Securities Exchange Act of 1934, 15 U.S.C. §78t(a), and the Virginia Securities Act, Va. Code §13.1-522(C). Williams and Kelly moved for summary

judgment, and their motion was granted by the district court. The district court held that "neither Williams nor Kelly were control persons of any liable party" and that both "lacked the requisite culpability for control person liability." *Dellastatious v. Williams*, 242 F.3d 191, 194 (4th Cir. 2001). The United States Court of Appeals for the Fourth Circuit affirmed the district court's decision.[15]

The Court noted that while both the federal and state statutes provided for control person liability, they both also provided "good faith" affirmative defenses for control persons. The Court noted further that "defendants must show that they did not act recklessly" in order to satisfy the Exchange Act's good faith defense, and "assumed" for purposes of its decision "that defendants must show that they acted reasonably in order to satisfy Virginia's good-faith defense." *Id.* at 194-95. For purposes of its analysis, the Court "assume[d], without deciding, that Williams and Kelly were control persons under both the federal and state laws," and thus framed the question before it as whether Williams and Kelly could avail themselves of the applicable good faith defenses. The Court ultimately concluded that Williams and Kelly "[we]re entitled to the good-faith affirmative defense under both federal law and Virginia's allegedly more-exacting standard" because they "carried their burden of proving that they acted reasonably." *Id.* at 195.[16]

The Court commenced its analysis by stating that "[a] defendant can satisfy the good-faith defense by demonstrating that he used reasonable care to prevent the securities violation," and that "[o]ne way to determine whether . . . [defendants] acted with 'reasonable care' pursuant to . . . [the state statute imposing control person liability] is to consider whether they complied with the duties established for directors under state law." *Id.* Further to this analysis, the Court held that the relevant Virginia statute permits directors to rely on, among other things, "financial statements prepared by corporate officers, legal counsel, or public accountants" provided that the directors "have no knowledge that makes reliance unwarranted." *Id.* at 196. Citing *Caremark*, the Court held further that "[i]n cases such as this, where shareholders allege that directors have insufficiently supervised the corporation's affairs, directors can avoid liability by showing that they attempted in good faith to ensure that an adequate corporate information-gathering and reporting system was in place." *Id.*

Applying these principles to the facts at hand, the Court concluded that "[i]t was reasonable for Williams and Kelly to delegate the creation and review of SAIL's offering documents to SAIL's officers . . . and their attorney." *Id.* Unlike the SAIL officers, each of whom possessed technical and/or financial expertise, and the attorney, who was "experienced in drafting offering documents," Williams and Kelly were "outside directors who served on LaserVision's board because they had invested . . . in LaserVision." *Id.* "They were not experts on the LaserVision technology and they had no role in SAIL's plan to market the technology." *Id.* Noting that the concerns of one of LaserVision's directors were raised with the board, the Court concluded that "the evidence show[ed] that SAIL's system for drafting and reviewing offering documents functioned properly." *Id.* In light of the foregoing, the Court concluded that Williams and Kelly satisfied Virginia's standards for directorial conduct,

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[15] Dellastatious settled his claims against the three SAIL officers, and the district court ordered judgment in Dellastatious' favor against SAIL and LaserVision.

[16] While not stated explicitly, the Court likely decided that it did not need not reach the control person issue in light of its holding that the good-faith defenses were applicable.

acted with reasonable care and, thus, could avail themselves of the good faith defense provided for by both Virginia and federal law.

McCall v. Scott, 239 F.3d 808 (6th Cir.), *amended on denial of rehearing by*, 250 F.3d 997 (6th Cir. 2001)

Plaintiffs in shareholder derivative action sufficiently alleged demand futility with respect to their claim against corporate directors for breach of the duty of care by setting forth allegations that presented "a substantial likelihood" of liability on the part of -- and, therefore, a reasonable doubt as to the disinterestedness of -- a majority of the board. The Court's "substantial likelihood of liability" finding was premised upon the directors' failure to act in the face of "red flags" that warned of widespread fraudulent billing practices at the company. The Court specifically held, however, that "there [wa]s not a substantial likelihood of liability based upon a failure to assure that reasonable reporting systems existed" because, although they ultimately failed to prevent the alleged fraud, audit procedures were in place at the company. *McCall v. Scott,* 239 F.3d 808, 820 n. 11 (6th Cir.), *amended on denial of rehearing by*, 250 F.3d 997 (6th Cir. 2001) ("*McCall I*").

Investors who owned shares in Columbia/HCA Healthcare Corporation ("Columbia"), brought shareholder derivative actions (subsequently consolidated in the instant action) on behalf of Columbia against certain past and present officers and/or directors of the company alleging intentional and negligent breach of their duty of care and intentional breach of their duty of loyalty. The allegations involved "allegedly wide-spread and systematic health care fraud by Columbia's hospitals, home health agencies, and other facilities." *Id.* at 813. The district court granted defendants' motion to dismiss the consolidated action for "fail[ure] to sufficiently allege demand futility . . . to excuse the failure to make a pre-suit demand on the Board of Directors." *Id.* The United States Court of Appeals for the Sixth Circuit affirmed the district court's dismissal of the duty of loyalty claim, but reversed the dismissal of the duty of care claim. Upon review and denial of petitions for rehearing or, in the alternative, for certification of an issue of law, the Sixth Court amended a section of its analysis relating to the duty of care claim without altering its ultimate holding.

With respect to the duty of care claim, "[p]laintiffs alleged that Columbia's senior management, with Board knowledge, devised [fraudulent] schemes to improperly increase revenue and profits, and perpetuated a management philosophy that provided strong incentives for employees to commit fraud." *Id.* at 814. Rejecting plaintiffs' contention that they adequately alleged a conscious board decision not to act, the Court stated that "[p]laintiffs' duty of care claims . . . ar[o]se out of allegations of nonfeasance by the Board (*i.e.*, 'intentional ignorance of,' or 'willful blindness to' the 'red flags' that were signs of potentially fraudulent practices)." *Id.* at 816. Plaintiffs "challenge[d] the Board's failure to take action or investigate under the circumstances." *Id.*

Turning to the legal standard for analyzing plaintiffs' failure to make pre-suit demand, the Court held that because plaintiffs' claims challenged the Board's failure to act, plaintiffs were required to allege "particularized factual allegations . . . creat[ing] a reasonable doubt that . . . [a majority of] the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." *Id.* (internal quotation omitted). The Court held further that plaintiffs could create this "reasonable doubt as to the disinterestedness of a director" by setting forth "particularized allegations in the complaint

[that] present a substantial likelihood of liability on the part of the director." *Id.* at 817 (internal quotation marks omitted).

Analyzing whether there was a substantial likelihood of liability on the part of a majority of the board, the Court, citing *Caremark*, held as a preliminary matter that corporate directors could be held liable for "breach of the duty to exercise appropriate attention to potentially illegal corporate activities," and that such liability could arise "from 'an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss.'" *McCall v. Scott*, 250 F.3d 997, 999 (6th Cir.), *amending on denial of rehearing*, 239 F.3d 808 (6th Cir. 2001) ("*McCall II*") (quoting *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996)). The Court held further that when the board's failure to act is based upon "ignorance of liability-creating activities, 'only a sustained or systematic failure of the board to exercise oversight -- such as an utter failure to attempt to assure a reasonable information and reporting system exists -- will establish the [necessary] lack of good faith.'" *Id.* (quoting *Caremark*, 698 A.2d at 971). The Court noted that imposition of liability in such circumstances makes sense because "ordinary business decisions of officers and employees deeper in the corporation can significantly injure the corporation and make it subject to criminal sanctions." *Id.*

Analyzing the "red flags" alleged to have been ignored improperly by Columbia's board -- including audit committee reports, acquisition practices, a *qui tam* action, and investigations conducted by federal agencies and the *New York Times* -- the Court held that, taken as a whole, they "presented a substantial likelihood of . . . liability for intentional or reckless breach of the duty of care [as to at least five of Columbia's directors]," which in turn "creat[ed] a reasonable doubt as to the disinterestedness of . . . [these] five . . . directors," and, therefore, as to a majority of Columbia's board. *McCall I* at 824. As such, the Court held that plaintiffs properly brought their duty of care claims without making pre-suit demand.

Of import, the Court specifically held that "there [wa]s not a substantial likelihood of liability based upon a failure to assure that reasonable reporting systems existed" in light of the fact that "nationwide audits, internal and external, were undertaken with attention to areas that could have legal ramifications for Columbia." *Id.* at 820 n. 11.

CIVIL LITIGATION

7.6 Antifraud

7.6.1 Pleading Requirements

***SEC v. Parnes, et al.*, No. 01-0763, 2001 U.S. Dist. LEXIS 21722 (S.D.N.Y. Dec. 21, 2001).**

In this action the SEC alleged violations of Section 10(b) of the Exchange Act, Rule 10b-5 promulgated thereunder, Section 17(a) of the Securities Act, (by a market manipulation scheme involving convertible debentures), Section 5 of the Securities Act, (by the sale of unregistered stock in the United States), and Section 7(f) of the Exchange Act, (by the execution of short sales and cash rather than margin accounts). The defendants moved to dismiss all of these claims. The court granted the motion with respect to some defendants and denied it as to others concerning the claims alleging fraud and denied all of the defendants' motions to dismiss the non-fraud claims. In granting the motion in part, the court determined the SEC had not plead fraud with sufficient particularity as to some defendants because the SEC's complaint referred to some defendants in the aggregate, without distinguishing their roles. The court wrote that "the SEC has had three years' discovery and access to records and documents. It cannot dispense, merely because a defendant invoked the Fifth Amendment privilege during the investigation, with the obligation to provide each defendant with fair notice of the specific conduct with which he is charged." Although dismissing those certain claims for failure to plead fraud with particularity, the court did so without prejudice and gave the SEC leave to replead.

7.6.2 Non-Disclosure

***SEC v. GLT Dain Rauscher, Inc., et al.*, 254 F.3d 852 (9th Cir. 2001).**

Before the Ninth Circuit was an appeal from the United States District Court for the Central District of California, which granted summary judgment to the defendant underwriter in an action brought by the SEC for a permanent injunction and civil penalties based on several securities laws relating to municipal securities offerings. The alleged violations of the securities laws stemmed from Kenneth D. Ough's acts and omissions as an investment banker for an underwriter of municipal offerings in his investigation and disclosure of the risks attached to the offering of certain taxable municipal notes. The SEC contends the district court erred in looking solely to the industry standard as the governing standard of care by which to measure Ough's conduct. Furthermore, the SEC asserted that there was a genuine issue of material fact as to what the industry standard was, and as to whether Ough's conduct departed from that standard or from a standard of "reasonable prudence," which the SEC contended was the appropriate standard. The Ninth Circuit determined that the industry standard was only one fact to consider in applying the broader standard of reasonable prudence. That standard, the court held, was the appropriate standard for evaluating Ough's conduct. The court found material fact disputes existed about (1) what a reasonably prudent

professional in Ough's circumstances would have done, (2) whether Ough's conduct satisfied that standard, and (3) whether Ough's failure, if any, to satisfy the applicable standard was so extreme to satisfy the scienter element of the securities anti-fraud statutes and regulations. Accordingly, the Ninth Circuit reversed the district court's grant of summary judgment for the defendant and remanded the case for further proceedings.

SEC v. Enterprises Solutions, Inc., et al., 142 F. Supp.2d 561 (S.D.N.Y. 2001). In this civil enforcement action, the SEC proved the defendants violated Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder showing the defendants knowingly and intentionally failed to disclose in Enterprises Solutions, Inc.'s Registration Statement defendant Herbert Cannon's real role in, and ownership of, the company. Cannon invoked his rights under the Fifth Amendment not to testify. The court said that the SEC was entitled to an adverse inference of the conduct alleged. The court also found that the defendants failed to disclose that the company's president and chief executive office, John A. Solomon, was chief executive officer of another company that had gone into bankruptcy, and that the company's press releases were materially misleading in that they falsely described the company's product as bondable, and used other phrases like "high integrity," "high assurance," and "strong assurance" to describe the product. Furthermore, the court found that Enterprises Solutions, Inc.'s website falsely represented that the company developed a suite of products and established business relationships with customers that would last a lifetime. As a result of these findings, the court held that the individual defendants, Cannon and Solomon, committed securities fraud. The court ordered disgorgement of profits from the fraud against Cannon and imposed civil penalties upon both defendants for their fraudulent conduct. The court also issued a permanent injunction as to future violations of the federal securities laws against Cannon, but refused to grant one against Solomon, finding the SEC failed to demonstrate that he was likely to commit future violations.

7.6.3 Definition of Security (Virtual Stock Exchange)

***SEC v. SG Ltd., et al.*, 265 F.3d 42 (1st Cir. 2001).**

The United States Court of Appeals for the First Circuit reinstated an SEC civil action against defendant SG Ltd. ("SG") in connection with an alleged pyramid scheme that SG ran as a "virtual stock market" through its website. In reversing the district court, the First Circuit found that facts as pleaded by the SEC could prove the existence of a "security," thus bringing the alleged scheme within the jurisdiction of the SEC. The defendant operated a website which offered internet users an opportunity to purchase shares in eleven different "virtual companies" listed on the website's "virtual stock exchange." The defendant arbitrarily set the purchase and sale prices of each of these imaginary companies in biweekly "rounds" and guaranteed that investors could buy or sell any quantity of shares at posted prices. SG placed no upper limit on the amount of funds that an investor could put away in its virtual offerings. The SEC alleged that at least eight hundred United States domiciliaries paid money to purchase virtual shares in the virtual companies listed on the website's exchange. The First Circuit applied the three-factor test set forth in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), and determined that these facts could prove the existence of an "investment contract" security. Accordingly, the court found that the facts as pleaded satisfied the *Howey* test and reversed and remanded the matter to the district court.

7.6.4 Reliance Element

***SEC v. Funding Resource Group, et al.*, No. 3-98-2689, 2001 U.S. Dist. LEXIS 12042 (N.D. Tex. July 27, 2001).**

A United States magistrate judge set forth written findings and a recommended disposition of the SEC's motion for partial summary judgment against defendants' Raymond G. Parr and Carl LaDane Weaver, concluding that the SEC's motion for partial summary judgment should be denied. The action arose out of the sale of non-existent "prime bank" securities. The magistrate judge characterized the scheme as "a classic ponzi scheme." The SEC alleged that the defendants raised more than $14,000,000 from unwitting investors by misrepresenting the use and safety of investor proceeds and the expected rate of return on their investments. In coming to its conclusion that the SEC's motion for partial summary judgment should be denied, the magistrate court remarked that the SEC failed to address the reliance element of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. Furthermore, the magistrate court explained that the SEC cited no actual evidence to support its proposition that the defendants never registered the offered securities with the SEC. The court concluded summary judgment was not proper absent such evidence.

7.6.5 "In Connection With" Requirement

***SEC v. Zandford*, 238 F.3d 559 (4th Cir. 2001).**

Defendant Charles Zandford, a securities broker, appealed from an order of the United States District Court for the District of Maryland, which granted summary judgment in favor of the SEC on its claims under Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. In a separate action, Zandford was convicted of thirteen counts of wire fraud for stealing from two of his investment clients. Subsequently, the SEC filed its civil action. The district court granted the SEC's motion for summary judgment having determined that Zandford's criminal conviction for wire fraud established all facts necessary to satisfy all elements of the SEC's securities fraud claims and that the doctrine of collateral estoppel prevented Zandford from contesting his civil liability. The Fourth Circuit reversed and remanded the case, holding the district court erred in holding that the doctrine of collateral estoppel prevented Zandford from contesting his civil liability. Moreover, the Fourth Circuit determined that the facts and elements implicated in Zandford's criminal trial were not necessarily the same facts and elements implicated in the SEC's civil action and, in fact, in this case, Zandford's fraudulent behavior, stealing his clients' money, was not sufficiently connected with a securities transaction for collateral estoppel to apply. The court wrote, "[t]he fact that Zandford's actions were reprehensible, however, does not relieve us of the obligation to determine whether his conversion of [his clients'] assets violated the federal securities laws."

7.6.6 Control Person Liability

***SEC v. Fitzgerald*, 135 F. Supp.2d 992 (N.D. Cal. 2001).**

In this securities fraud action, the court granted the SEC's application for a permanent injunction based on the SEC's allegation that the defendants violated the anti-fraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. Specifically, the SEC alleged the defendants sold securities in a land development project that they knew or should have known would result in a substantial loss and made misrepresentations or omissions in connection with those sales. The court found that the defendants committed a series of three material misrepresentations and/or omissions regarding the total amount and structure of the debt incurred on the construction project, the use of proceeds from offerings of securities, and the developer's contracts to sell the lots. The court also found that the defendant chairman and chief executive officer acted either negligently or with scienter as to the omissions and misrepresentations alleged by the SEC. Additionally, the court opined that to have control person liability under Section 20(a) of the Exchange Act and Section 15 of the Securities Act, the controlling person must establish that he acted in good faith and that he did not directly or individually induce the acts which constitute the violations. Here, the court concluded there was control person liability and that such liability is joint and several. Finally, the court concluded that there was a reasonable likelihood that the defendants would commit future violations absent an injunction, and therefore, granted the SEC's injunction.

7.6.7 Stock Price Manipulation

***SEC v. McCaskey, et al.*, No. 98-6153, 2001 U.S. Dist. LEXIS 13571 (S.D.N.Y. Sept. 4, 2001).**

In this securities fraud action, the SEC filed a complaint alleging that the defendant, Douglas G. McCaskey, violated the anti-fraud provisions of the federal securities laws in connection with a scheme to manipulate the market for Marcorp Inc. ("Marcorp") common stock, while he was president and a director of the company. The SEC maintained that McCaskey bought and sold Marcorp stock through accounts he controlled at various broker dealers located in the United States and Canada. Allegedly, McCaskey traded to and from his own accounts through "washed sales," "matched orders" and other transactions designed to create the illusion of active trading, and in this fashion artificially affected the price of Marcorp shares. Prior to the SEC moving for partial summary judgment in its civil action, McCaskey was convicted by guilty plea on criminal securities fraud charges related to the same activities. The court found that all questions in fact material to and underlying McCaskey's criminal conviction, as established during the plea allocution, bound McCaskey in the civil action. Consequently, the court granted the SEC's motion for partial summary judgment as well as the SEC's request for permanent injunctive relief and barred McCaskey from serving as an officer or director of a public company for six years.

***SEC v. Rosenfeld, et al.*, No. 97-1467, 2001 U.S. Dist. LEXIS (S.D.N.Y. Jan. 9, 2001).**

Pursuant to an entry of partial default judgment, the SEC sought damages from the defendant for violations of the Exchange Act. The SEC alleged the defendant was involved in a fraudulent scheme to falsely inflate the value of common stock and to evade the registration requirements of federal securities laws. In addition to awarding the SEC disgorgement and prejudgment interest, the court awarded the SEC third tier penalties pursuant to Section 20(d) of the Securities Act and Section 21(d) of the Exchange Act. The court found that third tier penalties were appropriate because the defendant's violations were not only fraudulent and deceitful but also they created a substantial loss or a significant risk of a substantial loss to investors who purchased stock at the inflated prices.

7.6.8 "Pump and Dump" Scheme

***SEC v. Poirier, et al.*, 140 F. Supp.2d 1033 (Ariz. 2001).**

The SEC's motion for summary judgment was granted in a case where the SEC alleged that the defendants participated in a classic "pump and dump" scheme by forming a company, acquiring shares in the company and disseminating false information into the market about the company to inflate share prices intending the sell off their shares at the inflated value before the false information was discovered. The court found that the defendants had violated multiple sections and rules under the Securities Act and the Exchange Act. Namely, the court found the defendants violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act, Rule 10b-5 promulgated thereunder, Section 5(c) of the Securities Act (prohibits any offer or sale of unregistered securities), Section 7(f) of the Exchange Act (governs the use of credit for the purchase of carrying of securities) and Sections 13(d) and 16 of the Exchange Act (beneficial ownership provisions). In granting the SEC's summary judgment, the court provided for injunctive relief, disgorgement of profits, payment of prejudgment interest, and civil penalties.

7.7 Insider Trading

7.7.1 Reporting Requirements

***SEC v. Lipson*, No. 97-CV-2661, 129 F. Supp.2d 1148 (N.D. Ill. 2001).**

The SEC filed a complaint alleging that the defendant committed securities fraud by selling a total of 365,000 of Supercuts, Inc. ("Supercuts") common stock on four occasions while he was in possession of material, non-public information that Supercuts would announce disappointing earnings. At the time of the sales, the defendant was chairman and chief executive officer of Supercuts. Based on these allegations of insider trading, the SEC alleged that the defendant violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. Additionally, the SEC alleged that the defendant as an officer, director and holder of more than ten percent of the company's stock, was obligated to report the four insider transactions to the SEC, but failed to do so, in

violation of Section 16(a) of the Exchange Act and Rules 16a-2 and 16a-3. A jury returned a verdict in favor of the SEC on the issues of liability under Sections 17(a), 10(b) and Rule 10b-5. The court found the defendant liable for failing to report the four transactions and determined that a civil penalty of three times the amount of losses avoided was appropriate given the defendant's high rank and responsibilities to shareholders at the company, the fact that the jury found the law to have been violated on four separate occasions, the failure of the defendant to take responsibility for his actions and to express remorse, the deterrent effect of such a sanction in light of the defendant's wealth and ability to pay, and the absence of any other legal forum in which sanctions were likely to be imposed. The court ordered a permanent injunction, disgorgement, prejudgment interest and penalties against the defendant.

7.7.2 Foreign Jurisdiction

***SEC v. Duclaud Gonzalez de Castilla*, No. 01-3999, 2001 U.S. Dist. LEXIS 12339 (S.D.N.Y. Aug. 15, 2001).**

In this insider trading action, the District Court for the Southern District of New York denied the defendants' motion to dismiss on the grounds of lack of personal jurisdiction pursuant to Fed. R. Civ. P. 12(b)(2). The underlying insider trading activity was based on one defendant's receiving and passing on to his friends and family inside information of an impending tender offer for CompUSA, Inc. ("CompUSA"). Each of the defendants made lucrative trades in CompUSA stock in the month prior to the public announcement of the tender offer. The moving defendants contend that the court lacked personal jurisdiction over them because they merely held joint bank accounts in the United States through which other defendants traded in CompUSA. In short, they contended that passive account ownership was insufficient contact to establish personal jurisdiction where the action arises out of trades made by other defendants. The court held that the allegations that the movants engaged in insider trading in an United States corporation traded on the New York Stock Exchange was sufficient to make out a prima facie case that they purposely availed themselves of the benefits of United States law and in so doing directly and foreseeably harmed United States investors. The motion to dismiss was denied with leave to refile after the close of discovery.

***SEC v. Alexander, et al.*, 160 F. Supp.2d 642 (S.D.N.Y. 2001).**

In this insider trading action, the court addressed a motion to dismiss the SEC's complaint on the grounds that it failed to plead fraud with particularity as required by Fed. R. Civ. P. 9(b) and one defendant's, Gianno Toffoli, motion to dismiss for lack of personal jurisdiction and forum non conveniens. Susi Belli was an employee of an Italian eyewear company named Luxottica Group S.p.A. ("Luxottica"). In her capacity as manager of public and investor relations of Luxottica, Belli became aware that the Italian company was considering acquiring a retail eyeglass operation in the United States named U.S. Shoe Corporation ("U.S. Shoe"). Belli shared the information with the other defendants who subsequently purchased stock and/or options in U.S. Shoe. The court denied the defendants' motion to dismiss on the grounds that the SEC failed to plead fraud with particularity but granted Toffoli's motion to dismiss for lack of personal jurisdiction. Toffoli argued that the requisite minimum contacts with the United States could not be established because, as a resident of Italy, her only relevant act was to sell shares of Luxottica, which is an Italian company, through her Italian

bank. The court found that the circumstances of Toffoli's transactions in Luxottica shares made it unlikely that her "acts presented 'unmistakably foreseeable effect[s] within the United States' that could 'reasonably be expected to be visited upon United States shareholders.'"

7.7.3 Remedies

***SEC v. Yun, et al.*, 148 F. Supp.2d 1287 (M.D. Fla. 2001).**

The SEC moved for civil remedies following a jury verdict against two defendants finding that both were liable for insider trading in violation of Section 10(b) of the Exchange Act. The SEC's action was based on the misappropriation theory. The core allegations were that Donna Yun, the wife of David Yun, president of the Book Fairs Division of Scholastic Corp. ("Scholastic"), tipped a friend and coworker, Jerry Birch, to an impending drop in the price of Scholastic stock. In reliance on this tip, Birch purchased a series of put options and sold them for a profit. The court granted the SEC's motion in part and denied it in part. The SEC sought against the defendants injunctions against future violations, disgorgement of ill-gotten gains, prejudgment interest plus civil penalties of three times the gain, the maximum amount under the statute. The court ordered the defendants to disgorge the profits of the insider trading scheme, ordering joint liability for the amount of disgorgement and awarded prejudgment interest liable against both traders. While the court did assess civil penalties, the amount as to each defendant was $100,000, which was less than a one half times penalty. Finally, the court refused to enjoin either defendant because their actions were isolated, were not egregious, and neither defendant had ready access to material and non-public information.

7.8 Fifth Amendment

***SEC v. Dunlap, et al.*, 253 F.3d 768 (4th Cir. 2001).**

In this appeal from the United States District Court for the Middle District of North Carolina, defendant Calvin Dunlap, Jr. appealed his civil contempt citation and incarceration. The contempt proceedings against Dunlap resulted from his failure and refusal to comply, on Fifth Amendment grounds, with a preliminary injunction order entered by the district court. The SEC alleged that Dunlap was the agent and control person of defendants Elfindepan, S.A. and Southern Financial Group ("Southern Financial"). The SEC had filed a complaint in district court and obtained a temporary restraining order against Dunlap and the two entities, as well as other defendants, to halt, and secure information concerning an allegedly fraudulent investment scheme. The Fourth Circuit held that to the extent the injunction and contempt orders required Dunlap to produce personal records, they had to be modified so as not to conflict with Dunlap's Fifth Amendment privilege against self-incrimination. Further, consistent with the district court's finding that Dunlap was the "control person" of Southern Financial, the Fourth Circuit held that Dunlap bore a responsibility for insuring that Southern Financial's existing business records were produced. The court also held that to the extent the injunction order required Southern Financial to prepare a new accounting, Dunlap's Fifth Amendment claim failed to provide protection to him. The Fourth Circuit also addressed Dunlap's assertion that Costa Rican law prevented his disclosure of certain business records in a United States court. It determined that the district court should evaluate and make

findings on that issue, and that those rulings on questions of law made in the district court would be subject to de novo review on appeal.

***SEC v. Leach, et al.*, 156 F. Supp.2d 491 (E.D. Pa. 2001).**

The SEC filed suit against LMC Assets Corp. and its corporate officers alleging that the defendants conducted fraudulent mini-tender offers through corporations created and controlled by the corporate officers, violating Sections 10(b) and 14(e) of the Exchange Act. Defendants Jeffrey Leach and LMC Assets Corp., which was controlled by Leach, sought a protective order excusing them from answering the complaint on the grounds that answering would violate Leach's Fifth Amendment privilege against self-incrimination. The court granted Leach's motion for a protective order but denied the corporation's motion for a protective order. In granting Leach's motion, the court agreed that since the SEC alleged the officer engaged in securities fraud for which criminal penalties were available, all facts relevant to the SEC's civil suit would also be relevant to a possible criminal proceeding. On the other hand, the court determined that the corporation had the ability to designate someone else other than Leach to answer the complaint without vitiating Leach's assertion of the Fifth Amendment privilege. The court ordered that the other corporate agent answer on behalf of the corporation or, if no such person existed, that the corporation's counsel could provide an answer.

7.9 Parallel Criminal Investigation

***SEC v. Montle, et al.*, No. 98-3446, 2001 U.S. Dist. LEXIS 17561 (S.D.N.Y. Oct. 26, 2001).**

The SEC filed a civil suit against a number of defendants including Paul J. Montle, Carole C. Martino, and her company CMA Noel Ltd. ("CMA"). All of the defendants settled with the SEC except for these two individuals and CMA. At a status conference, the court learned that the United States Attorneys' Office was conducting a criminal investigation of Martino. The court suggested that the criminal investigation should take precedence over the civil case and that depositions in the civil case should be held in abeyance to await developments in the criminal investigation. No stay in the civil suit was entered, and no party objected. The criminal case evolved and only a tax evasion case against Martino emerged. When this limited scope became evident, the SEC sought to continue discovery in the civil case. The court held in abeyance the SEC's motion to enter a preclusion order, denied the defendants' cross-motion for a stay and denied the motion to dismiss the action against defendants Martino and CMA.

7.10 Termination of Permanent Injunction

***SEC v. Coldicutt, et al.*, 258 F.3d 939 (9th Cir. 2001).**

In 1992, the United States District Court for the Southern District of California entered a permanent injunction by default against the appellant, Elizabeth L. Coldicutt, enjoining her from violating several sections of the federal securities laws and from selling or offering to sell any securities unless and until a registration statement for such securities had been filed with the SEC. Roughly six years after that default judgment, Coldicutt filed a motion under Fed. R. Civ. P. 60(b)(5) to terminate the permanent injunction. The district court denied the motion. On appeal, the Ninth Circuit noted that Coldicutt was no longer involved with the entities with which she worked prior to the injunction or any other securities enterprise, and that Coldicutt fully complied with the injunction and stated in the declaration that she would not re-enter the securities field. Nonetheless, the Ninth Circuit held that Coldicutt failed to demonstrate that compliance with the injunction has become substantially more onerous, unworkable because of unforeseen obstacles, detrimental to the public interest, or legally impermissible. The Ninth Circuit determined that the district court committed no clear error of judgment, did not fail to apply the correct law, and did not rest its decision on a clearly erroneous finding of material fact. Accordingly, the Ninth Circuit concluded the district court did not abuse its discretion in denying Coldicutt's motion under Rule 60(b)(5) to terminate the injunction.

7.11 Associated Person

***SEC v. Zahareas*, 272 F. 3d. 1102 (8th Cir. 2001).**

On this appeal from the United States District Court for the District of Minnesota, the United States Court of Appeals for the Eighth Circuit reversed the district court's summary judgment for the SEC and remanded the case with instructions for the district court to enter judgment in favor of defendant John M. Tuschner. The SEC had filed a civil enforcement proceeding against Tuschner and others, under Section 20(e) of the Exchange Act, alleging that Tuschner, a United States stock broker, exercised control over a foreign stock broker making the foreign broker an "associated person" of Tuschner in contravention of a bar order that prohibited the foreign broker from conducting business in the United States. The Eighth Circuit held that the SEC failed to show that the foreign broker was "controlled by" Tuschner. Looking at general principals of agency law, the Eighth Circuit noted that Tuschner did not control the foreign broker by (1) underwriting an initial public offering for stock the foreign broker obtained for Greek investors, (2) directing the foreign broker to transfer the Greek investors' accounts from Tuschner to someone else, and (3) providing forms used to establish the Greek investors' accounts.

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