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Representing Individual Defendants in Complex Securities Litigation

By Shannon Rose Selden

You've been retained to represent an individual defendant in a multiparty securities litigation—what should you do? The legal issues may be familiar—the allegations, pleading standards, claims, and procedures—but the particular dynamics of an individual representation within a complex case are somewhat unusual. Representing an individual defendant raises a host of unique strategic questions that have the potential to meaningfully affect your defense of the case. While this article does not—and could not—attempt to answer all of them, its goal is to provide a

basic framework for the strategic analysis. To assist counsel navigating these issues for the first or infrequent time, this article focuses on the pretrial phase of litigation, from retention by the client through summary judgment, and identifies the particular sensitivities that are likely to arise at each stage and questions to ask as the case proceeds.

Individual Dynamics

Representing an individual can be quite different from representing an entity or a

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Rebirth of Aiding-and-Abetting Liability in Private Securities Litigation?—Maybe

By Matthew Fornshell & Katherine Manghillis

On July 30, 2009, Democratic Senator Arlen Specter of Pennsylvania introduced Senate Bill 1551 (S.1551)—Liability for Aiding and Abetting Securities Violations Act of 2009. The proposed legislation¹ would amend section 20 of the Securities Exchange Act of 1934 to expressly allow for a private civil action against a person who provides substantial assistance in violation of such act.² If adopted, S.1551 would reverse two Supreme Court decisions rejecting aiding and abetting liability under section 10(b) and Rule 10b-5 of the 1934 act in private securities litigation—*Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.*,³ and *Central Bank of Denver v. First Interstate Bank of Denver*.⁴

Passage of S.1551 would immediately expand the universe of potential defendants in private securities lawsuits and would most

likely include third-party professional advisors to public companies (such as lawyers and accountants), as well as other corporations doing business with public companies and

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Representing Individual Defendants

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group—particularly if the representation arises during an enterprise- or career-threatening crisis. It's one thing to be named as a defendant in a strike-suit or due to one's position or title; it is something else to be targeted specifically during a major disruption to the business. Defendants in the former situation are less likely to have their own lawyer and those in the latter need someone they can trust, who will vigorously represent their interests during what can be a period of intense chaos and stress. In addition to the professional and personal disruption of litigation, financial exposure may also be a far more tangible and meaningful risk for the individual defendant. The individual's own personal assets are more likely to be genuinely in jeopardy, either because the company is refusing to indemnify and advance defense costs or it has the ability to refuse to indemnify and claw-back defense costs depending on the outcome. In short, while each person will react differently to a suit, being a named defendant has the potential to be intensely uncomfortable personally, professionally, and financially—particularly if the allegations involve securities fraud or other intentional misconduct. As counsel to the individual, you are in a unique position to help relieve the burden of the litigation by being both a forceful advocate and an effective advisor through the process.

Steps Following Initial Engagement

Co-representations

One of the first things to consider is whether your client is one of several who might benefit from sharing the same counsel. For example, traders managing the same or similar portfolios, individual partners in a defendant firm, or executives and officers of the company may face the same claims and allegations and be better served by consolidating their defenses. Joining forces can lead to a more fulsome understanding of the facts, a greater presence in discussions with codefendants and conferences with the court, and greater credibility in any discussions with plaintiffs or enforcement staff. A joint representation also removes uncertainty regarding the strategy and position of a critical codefendant. Although uncertainty can be reduced through coordination by counsel, two individuals whose interests are truly aligned may benefit from knowing that they are receiving the same advice and developing a single cohesive strategy.

Before taking on an additional representation,

defense counsel should make sure that there is no current conflict of interest and that they can adequately represent all of the prospective clients. An engagement letter with each client is essential and should clearly address the risks of the joint representation, including the risk that a conflict will arise. In doing so, it is important to specify how the conflict will be resolved (i.e., from which representation counsel will withdraw) and to obtain a waiver from the remaining client(s) of any claims for disqualification.

Informal Coordination

Whether you represent a single individual or small group of similarly situated individuals, it is essential to consider whether and how much you will be coordinating with counsel for the company and counsel for other individuals. Who will take the lead on various projects? Will each party submit separate briefs on every point, or can briefs be shared? What's the process for deciding such things? Will counsel split responsibility for various aspects of the factual or legal development of the case, or will each counsel separately take responsibility for everything? Do you trust each other?

Of all of the "relationship" questions, those affecting the interactions with the company—your client's current or former employer—may be the most complex. Depending on the facts and circumstances, the individual defendant and the company are likely both friends and actual, or at least potential, foes. The company may in fact be suing the individual or threatening to do so, it certainly may refuse to indemnify down the road if it hasn't already, and it may be threatening to hold back or claw back severance or compensation. Navigating a relationship where, on one hand, the individual and company are aligned as codefendants against a common set of claims, while, on the other hand, they are actual or potential adversaries, is tricky. Sometimes the adversarial issues are discrete and permit you to get the full benefit of the codefendant relationship while protecting your client's interest through careful management of the case and attention to nuance and detail. In other actions, each codefendant might be convinced that his or her ability to prevail against the common plaintiff depends primarily on his or her ability to distance themselves from each other. There, the adversarial issues may predominate over opportunities to coordinate and can effectively turn the defense into a two-fronted dispute—between the defendants

and plaintiffs, and among the defendants. Within any particular case, the balance will shift over time: Sometimes, the codefendant aspect of the relationship is preeminent; other times, the adversarial aspect of the relationship is paramount. Finding the right balance, both in the substantive positions you take in the litigation and in the way you deal with counsel, requires a deft hand and careful thought. Ultimately, there is no one right answer for how this works, and any answer will depend on the plaintiffs as well on the inter-defendant dynamic. The plaintiffs are out to get both the individual and the company, and sometimes what they are doing might also advance the individual's position against the company, but sometimes what they are doing might advance the company's position against the individual. Navigating these shifting temporary alliances to best effect is difficult—but the first step is recognizing that they exist, and realizing that managing them to your client's best advantage is an essential part of any defense strategy.

Joint-Defense Agreements

If you are coordinating with codefendants, you must understand the ground rules. The joint-defense privilege protects disclosures among parties who face a common legal challenge. It requires the parties to share an actual community of interest and protects only those communications exchanged pursuant to and in furtherance of their joint defense. Although such communications among a joint-defense group are protected under the common-law privilege even without a written agreement, many multiparty groups prefer to formalize the relationship and the protection in writing. Entering a joint-defense agreement should not be automatic, however. It is important to weigh the risks and benefits to your individual client and enter into an agreement that makes sense for his or her situation.

The written agreement formalizes each party's obligation to maintain the confidentiality of any joint-defense materials and confirms that their interests are aligned—which can be desirable or overly restrictive depending on your client's position in the group. Generally speaking, an individual defendant is more likely to be a recipient of information than a provider of it. If your client has little unique information to share with the group, he or she may not need the formal written restrictions on disclosure. At the same time, an effective defense may depend on information gathered and shared by company counsel, who may insist on participation in a written agreement. Your client's role in the underlying events should also inform the decision. A whistleblower

or innocent bystander may want to distance itself from the core defense group, while someone who fears being scapegoated or who played a central role in the contested events may want to formalize the "community of interest," be sure such clients are participating fully in the joint-defense strategy, and avoid letting them be marginalized or blamed by the core group. Regardless of your client's position, the decision to enter into a written joint-defense agreement should be considered not just a means to safely share and obtain joint-defense materials, but also as a critical step in positioning your client.

Indemnification/Insurance

Finally, counsel should determine at the outset whether the company will cover the costs of the individual's defense through any applicable insurance or indemnification arrangements. Even an agreement to indemnify poses risks, however. Many agreements contain a claw-back provision, which the company could invoke to recover any amounts paid under the agreement. The claw-back risk adds a layer of complexity to settlement and a layer of risk to trial, because if you lose at trial or settle independently, the client could both owe the plaintiff and face claw-back claims from the company. If there is an indemnification agreement but the company is not indemnifying, you may be forced to litigate (or threaten to litigate) that issue as well. This might be a counterclaim if they have sued your client, a cross-claim, or a separate action altogether. In any case, both counsel and client should understand the limits of the indemnification from the outset and manage the litigation in a way that makes sense financially.

Fact-gathering

Generally

Unlike company counsel, counsel to an individual will not have direct access to all of the documents and witnesses and must depend on cooperation and coordination to obtain information that may be essential to his or her client's defense. During the initial fact-gathering stage, counsel should consider what level of cooperation is possible, appropriate, and worth pursuing. Will the company share reports of witness interviews? Key

In a complex securities litigation, it is never too early to start thinking about whether to retain an expert.

documents? Expert analysis? The company may assist by providing the client's own email—and may even be willing and able to search its databases for other email and documents that mention the client. The response may vary drastically depending on the client's role and relationship to other defendants, but figuring out whether and how you might gain access is a crucial element of the fact-gathering phase.

Experts

In a complex securities litigation, it is never too early to start thinking about whether to retain an expert, and if so, who. For those involved in the trading or risk management of complex securities transactions, an expert may be essential to understanding the factual issues at the outset, in addition to analyzing causation and damages during the later stages. Securing an expert early in the litigation may be particularly important in a multiparty case, matters involving a narrow field of expertise, or any other action in which a number of defendants will be competing to retain experts from among a limited pool. Even if the bulk of the expert's work will come in later stages, you will have the widest array of experts to choose from early

Too much coordination can cloak meaningful differences in the allegations against each defendant—including deficiencies in the allegations against the individuals.

in the action, before your codefendants have begun to retain their own. If you do retain a strong expert, it is possible that other codefendants will ask to share in his or her work—submitting a single report from a testifying expert, for example, or sharing in the analysis provided by a consulting expert. If you can control the process, you may find coordinated use of a single expert is another means to ensure that similarly situated codefendants are on the same page, advancing the same arguments, and not working at cross-purposes. If, however, you need the expert to focus on issues unique to your client, a coordinated approach can dilute that effort, as more time is spent on issues of broader applicability. You may also find that it makes sense, given your client's circumstances, to seek to let someone else take the lead, and share in his or her expert's analysis. Seeking a partner for coordination on expert issues

may make particular sense for individuals who are more peripheral defendants or facing greater financial constraints, for example. In any sharing arrangement, all counsel must be highly attuned to the particular discovery issues associated with the use of experts—which are beyond the scope of this article, but certainly amplified as the number of participants increases.

Motions to Dismiss

Motions to dismiss in a complex multiparty case present critical strategic questions for individual defendants. The entity defendants (e.g., the company, underwriters, accounting firm) are likely to take the lead in drafting and may seek to coordinate the submissions of other defendants related to them. The accounting firm and its individual partners or former partners may file related briefs, as might the company and its officers. Separately represented individual defendants who are or were affiliated with an entity defendant will need to evaluate how closely aligned they can and should be with the party taking the lead on briefing. Coordination can be used to minimize duplicative (and possibly inconsistent) approaches and to present a forceful united front in favor of dismissal. Too much coordination, however, can cloak meaningful differences in the allegations against each defendant—including deficiencies in the allegations against the individuals.

In a complex multiparty securities-fraud case, for example, even a lengthy complaint may neglect to include sufficiently detailed allegations regarding an individual defendant, or improperly lump the individuals together—with each other or with the entity defendants. In preparing a motion to dismiss a section 10(b) fraud claim, counsel for the individual should scrutinize in particular the adequacy of any allegations of scienter and the attribution of any purported misrepresentations. A company defendant may contend, for example, that the allegations of scienter speak only to the individual defendants, but are insufficient to attribute scienter to the entity's action, while the individual defendant may challenge the allegations more directly, as insufficient to allege scienter at all. Judge Kram's opinion in *In re Take-Two Interactive Securities Litigation*,¹ is a good example of the kind of analysis that counsel to an individual defendant would like to encourage the court to undertake. In an action involving eight individual defendants, all of whom were former or current officers and directors of the two corporate defendants, Judge Kram found that the complaint had adequately alleged misleading statements, but carefully parsed the attribution of that statement to each of the individual defendants.² As the court noted, the

applicability of the group-pleading doctrine may determine the adequacy of the allegations. Under the group-pleading doctrine, certain documents—such as the annual reports and quarterly disclosures of the company—are attributable to individual defendants by their position in the company, not by their direct authorship of the alleged misrepresentation.³ While a number of circuits have rejected the group-pleading doctrine as inconsistent with the particularity requirements of the Private Securities Litigation Reform Act (PSLRA),⁴ in jurisdictions where it applies, the group-pleading doctrine permits plaintiffs to state a claim for securities fraud under section 10(b) and Rule 10b-5 against individual defendants without having to link each defendant to a specific misrepresentation. For the individuals, any motion to dismiss should consider first whether the doctrine applies at all and second, whether the complaint adequately alleges that they are the particular type of defendant who is subject to the group-pleading doctrine due to his or her high-level position inside the company and “direct day-to-day involvement at the entity issuing the statement.”⁵

In addition to the proper attribution of the alleged misrepresentations, counsel to individual defendants should be particularly attuned to the adequacy of allegations of scienter. Scienter allegations by their nature must be personal—with respect to each defendant, the plaintiff must allege facts giving rise to a strong inference that the defendant acted with the “intent to deceive, manipulate or defraud.”⁶ Following the Supreme Court’s decision in *Tellabs*, the inference of scienter must be cogent and “at least as plausible” as nonculpable explanations. To support that inference, for example, the Second Circuit requires plaintiffs to allege facts showing that the individual “had both the motive and opportunity to commit the fraud” or “constituting strong circumstantial evidence of conscious misbehavior or recklessness.”⁷ Allegations of motive must establish a concrete, personal benefit to the defendant; benefits or motives shared generally by corporate officers and directors do not suffice.⁸ An individual defendant’s motion to dismiss will want to focus in particular on elements such as this: Where the allegations must be sufficiently specific with respect to that individual, a targeted motion to dismiss can be an effective supplement to coordinated briefing by the entities.

Discovery

Discovery offers another opportunity for extensive cooperation, although it, too, will vary depending on the individual defendants’ role in the broader group.

First, it is essential to make sure that the client has fulfilled any obligations to provide documents to the

company—an employee, for example, should comply with the litigation hold and collection efforts. Compliance can raise sensitive issues for some defendants, and not just the obvious concerns that might arise from documents inculcating the defendant or others. Counsel should collect, image, and review the documents before turning them over, and should manage that process to mitigate any concerns the documents may raise. If a former or current employee has surrendered all of his or her business records and documents to the company, he or she may be able to reach agreement with the plaintiffs that duplicative production is not required, leaving counsel free to focus on any unique issues.

Depositions can present a particular challenge where multiple parties seek to question the same witness in a limited time frame. Ascertaining in advance who will take the lead, what topics they expect to cover, and what exhibits they expect to use can alleviate some of the uncertainty, but even effective questioning may not focus on the specific issues relevant to a particular individual defendant, including, for example, questions of intent and participation in any alleged misrepresentations. Counsel to an individual defendant must be prepared to be flexible, and to supplement his or her own outline of critical issues with follow-up questions necessary to clarify earlier testimony. Aside from the substance, it is important to think strategically about how to negotiate the other competitors for questioning time, how much time to press for, and how and when best to assert your interest in posing questions. Each case will have its own dynamic, but the key for individual defendants is to balance the ability to rely on some of the larger-entity defendants where appropriate with the need to supplement with discovery on individual issues.

Summary Judgment

Like the motions to dismiss, summary judgment presents an opportunity to distinguish the individual defendant from the group—and to take advantage of arguments common to all defendants presented in the entity defendants’ briefs. Because of the fact-intensive nature of summary-judgment briefing, individual defendants may find it useful to press for a staggered briefing schedule, enabling them to submit motions or oppositions some time after the entity defendants. Courts are often sympathetic to such schedules, as they alleviate the total volume of briefing and of exhibits, and enable the court, as well as the individual defendants, to focus on the issues specific to their claims or defenses. As with briefing on a motion to dismiss, coordinated summary judgment runs the risk that others will not argue the same points

as effectively as the individual would like, or will present them in a way that is less useful to your client than you would like. Again, coordination with other counsel in advance, including the exchange of drafts, can help to alleviate some of those concerns. Also like the motion to dismiss, summary judgment presents an opportunity to focus on the discrete issues like scienter, the making of alleged misrepresentations, and reliance that may be unique to the individual defendant—whereas the entities may carry more of the weight on statistical expert analysis and loss causation, or statements made in the registration statements and prospectuses.

Settlement

At any stage in the litigation, settlement also involves special considerations for an individual. Obviously, an individual defendant who seeks to settle would prefer to be swept into the company settlement—and that is typically easy to do *if* he or she is indemnified. But individuals who are not indemnified and are contemplating settlement face a host of strategic considerations. Peripheral defendants may find that plaintiffs are willing to settle with them very early, to focus on the parties they view as more significant players (and deeper pockets). Other individuals may find that they are at the very back of the line for any settlement discussions, and that plaintiffs have no interest in reasonable discussions until they have extracted substantial settlements from the entity defendants. Defendants in class actions also may find that the calculation is affected by the PSLRA provisions regarding settlement discharge.⁹ If your client's settlement would significantly reduce the amount of any final judgment because a verdict would be likely to attribute a substantial percentage of the responsibility for the losses to your client, plaintiffs have an incentive to settle the individual claims last to avoid the risk that they will substantially reduce the plaintiff's recovery from other defendants. High-profile defendants also may face a particular challenge as plaintiffs may be less motivated by a financial cost-benefit analysis and more interested in the atmospheric advantage of keeping a familiar face in the litigation.

Whether and when it makes sense to discuss settlement is obviously a more personal decision—psychologically as well as financially—for an individual defendant than for a company. That may be especially true if the individual is not fully indemnified or facing claw-back, but is frequently the case even for those who are assured that the company will pay. Individuals may place a premium on the damage to their reputations rather than the cost of litigation, and decide to litigate

or structure a settlement accordingly. Some defendants may be anxious to end any involvement in the litigation and eager to begin talks at the first opportunity. Others may conclude that they are willing to endure the cloud of litigation in the expectation that they will get a better deal by waiting to settle after the major players are out and plaintiffs have moved on to newer, more lucrative matters. Even if an early exit provides an appealing opportunity for a low-cost settlement, some individuals will decide that defending the action has greater personal value, even if it comes at a higher cost. The essential issue for counsel is to understand where the client's priorities lie, making sure they fully comprehend—not just acknowledge—the risks and benefits of each alternative, and to help each client identify and achieve the best result for his or her personal situation.

Conclusion

While this article ends with settlement, many individual cases will not. Individual defendants can and do often go to trial whether or not their codefendants remain in the case. With luck, the questions posed here will help counsel position their clients for that trial to be successful. ✱

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1. 551 F. Supp. 2d 247 (SDNY 2008).
2. *See In re Take-Two Interactive Sec. Litig.*, 551 F. Supp. 2d 247, 265–66 (SDNY 2008) (“Having held that the [second amended complaint] adequately alleges a materially misleading statement in Take-Two’s 2004 and 2005 Forms 10-K, the Court must now ascertain to whom the SAC adequately attributes that misleading statement.”).
3. *See, e.g., In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 433, 449 (S.D.N.Y. 2005).
4. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 710 (7th Cir. 2008) (rejecting the group-pleading doctrine); *Winer Family Trust v. Queen*, 503 F.3d 319, 337 (3d Cir. 2007) (same); *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 364 (5th Cir. 2004) (same).
5. *In re Alstom*, 406 F. Supp. 2d at 449; *In re Take-Two Interactive Sec. Litig.*, 551 F. Supp. 2d at 266–67.
6. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* 551, U.S. 308, 313 (2007).
7. *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 168–69 (2d Cir. 2000).
8. *Kalnit v. Eichler*, 264 F.3d 131, 138 (2d Cir. 2001).
9. 28 U.S.C. § 78u-f (section 21D(f)).

Aiding-and-Abetting Liability

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their own directors and officers. Given the impact this legislation may have on these various constituencies, it appears certain that a political battle will ensue as S.1551 progresses. In fact, Columbia University Law School professor John C. Coffee testified that “[R]estoring aiding and abetting will be controversial. A solid phalanx of professions—law firms, accounting firms, investment banks, and credit rating agencies—will unite to oppose such restoration.”⁵

A Brief Historical Perspective on Aiding-and-Abetting Liability

Section 10(b) of the 1934 act makes it “unlawful for any person, directly or indirectly . . . [t]o use or employ in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance. . . .”⁶ Rule 10b-5, adopted by the Securities and Exchange Commission (SEC) in 1942, likewise makes it unlawful “for any person, directly or indirectly, . . . [t]o employ any device, scheme or artifice to defraud . . . in connection with the purchase or sale of any security.”

Although nothing in section 10(b) or Rule 10b-5 expressly provides for a private right of action, since 1946, private litigants have been availing themselves of these provisions as a remedy for fraud.⁷ It was not until a 1971 ruling that the private right of action was officially recognized by the Supreme Court.⁸ In *Superintendent of Insurance of the State of New York v. Bankers Life and Casualty Company*, the Supreme Court stated:

When a person who is dealing with a corporation in a securities transaction denies the corporation’s directors access to material information known to him, the corporation is disabled from availing itself of an informed judgment on the part of its board regarding the merits of the transaction. In this situation the private right of action recognized under Rule 10b-5 is available as a remedy for the corporate disability.⁹

Following that 1971 decision, there was a general consensus among the federal courts that a private cause of action under section 10(b) and Rule 10b-5 reached not only those people who actually made a material misstatement, but also to those who aided and abetted such a violation.¹⁰

However, the private-securities-litigation landscape changed in 1994, when the Supreme Court ruled in *Central Bank* that there is no private cause of action for aiding and abetting securities fraud under section 10(b) of the 1934 act. In *Central Bank*, the Court held that Congress did not intend for the “directly or indirectly” language of section 10(b) to cover aiding and abetting, because liability for aiding and abetting would extend beyond people who actually engaged in the deceptive act.

The Supreme Court noted:

the absence of §10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met.¹¹

Following *Central Bank*, a bill was introduced in Congress to overturn *Central Bank* and extend aiding-and-abetting authority to private litigants. In 1995, Congress enacted the Private Securities Litigation Reform Act (PSLRA), but language extending liability for violations of section 10 and Rule 10b-5 in private securities litigation to those who aid and abet a violation was rejected. Rather, the PSLRA sought to curb abusive securities class-action litigation, added a heightened pleading requirement, and confirmed the right of the SEC to prosecute aiders and abettors of securities fraud.

Most recently, the Supreme Court’s 2008 decision in *Stoneridge* affirmed *Central Bank* and once again found that no private right of action for aider-and-abettor liability exists under section 10(b). There the Court examined the issue of “when, if ever an injured investor may rely upon §10(b) to recover from a party that neither makes a public misstatement nor violates

It was not until a 1971 ruling that the private right of action was officially recognized by the Supreme Court.

a duty to disclose but does participate in a scheme to violate §10(b).¹²

It is important to note that *Central Bank* and *Stoneridge* only exclude liability when the secondary defendants have made no false statement themselves. Were they to make misrepresentations upon which investors rely (such as certifying false financial statements), secondary defendants can and will be held liable as primary violators.

S. 1551—A Silver Bullet or a Dagger in the Heart?

On September 17, 2009, S.1551 had its first committee hearing before the Subcommittee on Crime and Drugs of the U.S. Senate Committee on the Judiciary. The hearing served to reignite the long standing debate

over the need for private civil liability to deter securities fraud and compensate securities-fraud victims versus the need to avoid exposing innocent corporations and professionals to frivolous litigation and the associated expense.

At the hearing, Professor Adam Pritchard of the University of Michigan and Robert J. Giuffra, Jr., a partner at Sullivan & Cromwell and former chief counsel, U.S. Senate Banking Committee (1995–1996), separately gave testimony opposing S.1551.

They presented two main arguments against S.1551: (1) The PSLRA correctly left to the SEC and the Department of Justice the sole responsibility for asserting securities claims against secondary actors; and (2) creating a private cause of action for aiding and abetting liability would hurt the competitiveness of the U.S. capital markets and financial centers and would vastly expand the potential liability and litigation expenses for innocent third parties.¹³

Giuffra also argued that S.1551’s “recklessness” standard is too vague and amorphous. He stated that “by not at least adopting a strict definition of ‘recklessness,’ courts likely would view S.1551 as watering down the current standard for alleging fraudulent intent to something approximating negligence or, at best, gross negligence.”¹⁴ Giuffra argued that the result would be more cases surviving motions to dismiss, leaving companies with no choice but to settle weak securities cases to avoid the expenses of

litigation and the risks of a large judgment.

The combination of an undefined “substantial assistance”—conduct that in itself may be perfectly legal—and a nebulous “recklessness” standard that does not require that the accused party have any actual knowledge that its conduct in some way assisted a fraud not only gives plaintiffs’ lawyers a “hunting license,” but creates such uncertainty about the legal standard that the pressure to settle cases (rather than risk a jury trial in which damages could be billions of dollars) will be overwhelming.¹⁵

In other words, if lawyers can be held liable for statements made in their client’s public disclosures, then the law of fraud is transformed from a “sanction for misleading people into a sanction for failing to uncover fraud committed by others.”¹⁶

The case in favor of passing S.1551 was made by the North American Securities Administrators Association (NASAA) and Change to Win, an alliance of unions that seek to protect union members’ pensions by monitoring corporate activity. Coffee also testified in favor of the legislation.

NASAA presented testimony through State of Illinois Securities Department director Tanya Solov. NASAA opined that private civil actions against aiders and abettors “are a necessary and important complement to state and federal actions,” particularly in light of limited governmental resources.¹⁷ NASAA asserted that, in the absence of private investor suits, “there will be no deterrent effect to prevent [secondary actors] from engaging in fraudulent schemes.” NASAA argued that if Congress does not restore aiding-and-abetting liability, then innocent victims of fraud will be left without a remedy against entities that assisted in perpetrating the fraud. NASAA further opined that “[g]iven the recent financial scandals and corporate fraud, this legislation is a positive step in restoring accountability and the integrity of the U.S. markets.”

Change to Win presented testimony from its general counsel, Patrick J. Szymanski, and advocated for a broader “overhaul of federal financial regulation” that “must remove two significant barriers to investor claims”—*Tellabs, Inc. v. Makor Issues & Rights, Ltd.*¹⁸ and *Stoneridge*. Change to Win’s testimony concluded that the assets of people who “knowingly or recklessly facilitate financial fraud” should be available to victims of fraudulent activity.

Coffee generally endorsed S.1551, but recommended to

Commentators have argued that the political and economic events of the past two years make the passage of S.1551 much more likely.

the committee that the measure include a limitation on the amount of damages that private litigants may recover.¹⁹

As an initial matter, Coffee observed that civil aiding-and-abetting liability is not a novel concept and that it was “well-established” before *Central Bank*. Coffee argued that during that time, there was no evidence that such liability resulted in major failures or bankruptcies or that it drove firms out of the industry. Coffee concluded that “predictions of doom and disaster from restoring private civil liability seem unfounded.”

Coffee’s testimony provided two rationales for why Congress should restore private liability for aiding and abetting securities violations: compensation and deterrence.

From a compensation prospective, Coffee noted that typical securities class actions are incapable of achieving compensatory relief because of its circularity.²⁰ However, if a cause of action for aiding and abetting were recognized, secondary defendants would represent a significant source of compensation for injured investors. He stated that “in a very real sense, recoveries from secondary participants uniquely provide compensation to shareholders, while recoveries from issuer corporations may seldom do so.”

From a deterrence prospective, Coffee argued that restoring private liability for aiding-and-abetting violations makes sense because: (1) The critical gatekeepers of the capital markets—accountants, investment banks, securities analysts, credit-rating agencies, and sometimes law firms—will not otherwise face liability and will remain undeterred in most instances; (2) those gatekeepers can be more easily deterred than the primary violator because they do not stand to receive the same gain as the primary violator; and (3) if the gatekeepers are adequately deterred, they will block transactions, even though the primary violator would willingly proceed with them.

Coffee was mindful of the main downside to S.1551—increasing the potential for strike suits against innocent secondary actors. However, he argued that the “opening the floodgates” argument is overstated. The argument may have been valid in 1994 when the Supreme Court delivered its ruling in *Central Bank*, but the protections afforded by the PSLRA have reduced the threat of frivolous litigation through the heightened pleading standards. Coffee testified that “[T]he net result is that secondary defendants in most cases will be able to obtain early dismissals at the motion to dismiss stage and will be protected by the proportionate liability standard so that they can settle well within their insurance coverage.”

Reasonable minds, legal scholars, and politicians

can probably rationalize a position either supporting or not supporting S.1551. Regardless, it appears clear that this legislation is either the “silver bullet” needed to deter fraud in our financial system and compensate its victims or a “dagger in the heart” of our market competitiveness. Primary and secondary market players may be left to recover from wrenched necks caused by the repetitive motion associated with constantly looking over one’s shoulder.

Likelihood of Success

Commentators have argued that the political and economic events of the past two years have resulted in a particularly strong public sentiment in favor of holding “gatekeepers” accountable, thus making passage of S.1551 substantially more likely.²¹

However, there are other indicators that tend to point in the direction of a successful outcome for S.1551. First, in a March 17, 2009, opinion and order, Judge Gerard E. Lynch, then of the Southern District of New York,²² dismissed securities claims against outside counsel and held that the allegations failed to state securities-fraud claims against outside counsel as a primary violator of the federal securities laws.

In dicta, Judge Lynch observed:

It is perhaps dismaying that participants in a fraudulent scheme who may even have committed criminal acts are not answerable in damages to the victims of the fraud. However, as the Court noted in *Stoneridge*, the fact that plaintiff-investors have no claim is the result of a policy choice by Congress. In 1995, in reaction to the Supreme Court’s decision in *Central Bank*, Congress authorized the SEC—but not private parties—to bring enforcement actions against those who “knowingly provide [] substantial assistance to another person” in violation of the federal securities laws . . . This choice may be ripe for legislative re-examination. While the impulse to protect professionals and other marginal actors who may too easily be drawn into securities litigation may well be sound, a bright line between principals and accomplices may not be appropriate.²³

This commentary from such a well-respected judge acts as an invitation to Congress to reexamine whether private parties should be able to bring a cause of action against secondary actors for aiding and abetting.

Second, there is concern with leaving aiding-and-abetting enforcement actions exclusively with the SEC. In the wake of the SEC's many missed opportunities to uncover the Madoff and Stanford Ponzi schemes, the SEC's regulatory credentials are held in particularly low regard. Many have questioned whether it is wise to rely exclusively upon the SEC to bring enforcement actions against those persons guilty of aiding and abetting. For example, in his written testimony, Coffee stated:

Given the severity of the current financial crisis, the only possible justification for not unleashing private enforcement is the belief that adequate deterrence can come from public enforcement alone. But can it? To pose this question in a more pointed fashion, *does anyone really believe today, in this post-Madoff world, that the SEC, by itself, can adequately deter most secondary participants in securities frauds?*

Finally, Coffee's proposed amendment to S.1551, placing a ceiling on liability for secondary defendants, could also increase the likelihood of S.1551's passage. Coffee's proposal creates a ceiling on damages for natural persons at \$2 million and in the case of a public corporation (i.e., an investment bank or a rating agency); the maximum ceiling would be \$50 million. Coffee noted that "the real impact of a ceiling is to induce the parties to settle for an amount beneath the ceiling (because few, if any, will settle for an amount equal of their maximum exposure to liability)."²⁴

If passed, S.1551 would represent the next major shift in the evolution of private securities litigation since adoption of the PSLRA. In addition to extending 1934 act liability to anticipated, and perhaps unanticipated third parties, it will likely have major implications for directors-and-officers insurance coverage, professional liability insurance underwriters, and the cost of third-party professional services for public companies. If the last 12 months have taught us nothing else, they have confirmed the need for robust regulation of the securities markets. S.1551 may well be the next method of market regulation to keep the markets and its participants honest. ✱

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1. S.1551 seeks to amend §20(e) of the 1934 act (15 U.S.C. §78t(e)) to include a new subsection (2), which would provide:
PRIVATE CIVIL ACTIONS—For purposes of any private civil action implied under this title, any person that knowingly or recklessly provides substantial assistance to another person in violation of this title, or of any rule or regulation issued under this title, shall be deemed in violation of this title to the same extent as the person to whom such assistance is provided.
2. Statements on Introduced Bills and Joint Resolutions, July 30, 2009, by Mr. Specter (for himself, Mr. Reed, and Mr. Kaufman), available at <http://thomas.loc.gov>.
3. 522 U.S. 148, 128 S.Ct.761 (2008).
4. 511 U.S. 164 (1994).
5. *Hearing on "Evaluating S.1551: The Liability for Aiding and Abetting Securities Violations Act of 2009" Before the Subcomm. on Crime and Drugs of the S. Comm. on the Judiciary*, 111th Cong. (2009) [hereinafter *Hearing on S.1551*] (testimony of Prof. John C. Coffee Jr.).
6. 15 U.S.C. §78j.
7. *Kardon v. Nat'l Gypsum Co.*, 69 F.Supp. 512, 513 (E.D. Pa. 1946).
8. *Superintendent of Ins. of the State of N.Y. v. Bankers Life and Casualty Co.*, 404 U.S. 6, 13 at fn.9 (1971) (stating: "It is now established that a private right of action is implied under §10(b). (citations omitted)).
9. *Id.* (quoting *Shell v. Hensley*, 430 F.2d 819, 827 (5th Cir. 1970)).
10. *See e.g.*, *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 777 (1st Cir.1983); *First Interstate Bank of Denver v. Pring*, 969 F.2d 891, 898, n.13 (10th Cir.1992); *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731, 740 (10th Cir.1974), *but see* *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495 (7th Cir.1986).
11. 511 U.S. at 191. In a typical §10(b) private action, a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation. *Stoneridge*, 128 S.Ct. at 768 (citation omitted).
12. 128 S.Ct. at 767.
13. *Hearing on S.1551, supra* note 5 (testimony of Robert J. Giuffra) (warning that if S.1551 passes, it would expand the risk of liability for the very businesses that Congress has supported under the TARP program). Similarly, Pritchard testified that 80 percent of the TARP funds have gone to financial institutions that have been named as defendants in recent securities class actions. As a result, instead of spending their capital making loans (thereby growing the U.S. economy), the financial institutions are faced with the inevitable increase in expenses. *Hearing on S.1551, supra* note 5 (testimony of Adam C. Pritchard).
14. *Hearing on S.1551, supra* note 5 (testimony of Robert J. Giuffra).
15. *Id.*

16. *Hearing on S.1551, supra* note 5 (testimony of Professor Adam C. Pritchard).

17. *Hearing on S.1551, supra* note 5 (testimony of Tanya Solov). Ms. Solov noted that many more cases of fraud were not pursued by regulators due to the regulators' limited resources. Ms. Solov quoted SEC Chairman Mary Schapiro who stated: "Quite frankly, our enforcement and examination resources have been seriously constrained in recent years."

18. 551 U.S. 308 (2007). In *Tellabs v. Makor Issues & Rights, Ltd.*, the Supreme Court held that in a section 10(b) action, a plaintiff "must plead facts rendering an inference of scienter at least as likely as any plausible opposing inference."

551 U.S. 308, 328 (2007). Change to Win argued that the standard announced by the Supreme Court in *Tellabs* "is ambiguous, subjective, unworkable and fatal to many meritorious securities actions." *Hearing on S.1551, supra* note 5 (testimony of Patrick J. Szymanski).

19. *Hearing on S.1551, supra* note 5 (testimony of Coffee).

20. Coffee explained that:

when the corporation pays damages in a secondary market case, this payment is borne by its shareholders. Thus, shareholders who purchased or sold within the class period win . . . , whereas those shareholders who fall outside the class period lose. But because most shareholders are diversified, they fall into both camps, sometimes winning and sometimes losing. The net result is a series of pocket-shifting wealth transfers that in the aggregate leave shareholders worse off. . . .

21. Kevin LaCroix, *Specter's "Aiding and Abetting" Bill: Why it Could Pass and Why it Matters*, *The D&O Diary*, September 21, 2009, www.dandodiary.com/2009/09/articles/securities-litigation/specters-aiding-and-abetting-bill-why-it-could-pass-and-why-it-matters.

22. On September 17, 2009, the Senate confirmed Judge Lynch's nomination to the Second Circuit Court of Appeals.

23. *In re Refco Sec. Litig.*, 609 F.Supp.2d 304, 319 n.15.

24. *See Hearing on S.1551, supra* note 5 (testimony of Coffee).



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Get Your Priorities Straight to Maximize Your D&O Coverage

By John C. Tanner

Your company has been embroiled in securities class-action and derivative litigation for years with one of the largest securities-plaintiff law firms in the nation. Your general counsel (GC) informs you that the company has finally negotiated a settlement of the securities class-action and tagalong derivative lawsuits for \$150 million. The parties have allocated \$125 million to settle the securities class-action claim and \$25 million to settle the derivative matter, which is non-indemnifiable under the applicable state law.

Fortunately, your company purchased \$150 million of directors and officers (D&O) insurance consisting of \$125 million of traditional D&O coverage for the company and its directors and officers, as well as \$25 million of that special excess “sleep insurance” you recommended to the CEO a few years ago called Side A Difference-In-Conditions coverage (also known as Side A DIC coverage). Now that the matter is resolved, the GC and CFO ask you to collect the \$150 million from the company’s insurers so the company’s board can put this matter behind it and focus attention on continued profitability and revenue growth.

The GC kept the company’s insurers fully informed throughout the litigation and sought advance consent to the proposed settlement terms. The upper excess layers were contacted very late during the mediation process, but each agreed not to raise lack of consent or otherwise object to the reasonableness of the settlement amount.

The settlement is for \$150 million and you have \$150 million of available limits, so there shouldn’t be much of an issue. Right? WRONG. The Side A DIC insurers refuse any payment and tell you that the extra \$25 million is the responsibility of the underlying primary D&O insurance. You have a meeting scheduled for early Monday morning to inform the GC, CEO, and CFO that the sleep insurance will not pay. Good luck sleeping.

This simple fact pattern (based on a true story) highlights a hidden issue of how a standard priority-of-payments provision contained in a D&O policy can lead to surprising, if not unintended, results.

What Is a Priority-of-Payments Provision?

A typical D&O policy will include coverage for Side A loss (coverage for individual directors and officers where the company cannot legally or financially fund

indemnification), Side B loss (coverage for the company essentially reimbursing the company for its indemnification and advancement payments to individual directors and officers), and separate Side C loss (direct coverage for the company itself). Under standard policies, Side A, B, and C coverage share the same aggregate limits of liability such that payment of a Side B or Side C claim will exhaust the available limits of liability for Side A protection and vice versa.

Priority-of-payments provisions are common in traditional A/B/C D&O policies and are intended to govern the order of payments when amounts are potentially due under more than one insuring clause. A typical priority-of-payments provision provides that any payments under the D&O policy will be paid first under Side A to protect the assets of individual directors and officers before any payments can be made to the company under the Side B or Side C insuring clauses.

Such provisions obviously offer comfort to individual directors and officers in the context of claim exposure exceeding the available insurance limits. Priority-of-payments provisions have also been cited in numerous court opinions as justification for the courts’ holding that a D&O policy’s proceeds fell outside the bankruptcy estate. Many companies now purchase dedicated excess Side A DIC coverage for directors and officers as additional protection against entity-coverage dilution of limits and/or as a further hedge against a bankruptcy court preventing individual access to the D&O proceeds at a time when needed most. Because the Side A DIC coverage only covers individuals for non-indemnifiable loss, there is no corporate dilution of limits and a corporate bankruptcy should not affect individual access to the Side A DIC limits.

Why Did the Side A DIC Insurers Refuse?

In the above scenario, the company purchased \$125 million of traditional shared A/B/C coverage and an additional \$25 million of dedicated excess Side A DIC coverage that only covered Side A loss where the directors and officers did not receive indemnification. The settlement allocated \$125 million to the securities class-action claim and \$25 million to settle the derivative matter, which was non-indemnifiable under the applicable state law.

The Side A DIC insurers pointed to the priority-of-payments provision in the traditional A/B/C coverage,

which granted absolute priority to payment of Side A loss over any indemnifiable corporate claim. As a result, the priority-of-payments wording obligated the traditional A/B/C coverage to first fund the \$25 million non-indemnifiable derivative matter before any further payment could be made.

While the company may have assumed that it could allocate the \$25 million of Side A DIC limits to settle the derivative litigation, the priority-of-payments provision meant that the \$125 million traditional D&O limits would fund the \$25 million derivative settlement first and only then fund any remaining indemnifiable loss. As a result, the remaining \$100 million of the \$125 million traditional limits could be applied to the class-action settlement—leaving \$25 million uninsured. The \$25 million Side A DIC limits did not respond to the class-action settlement, which was an indemnifiable Side B and C claim, but remained unimpaired and available to fund other outstanding non-indemnifiable loss.

How Should a Risk Manager Prioritize the D&O Coverage to Maximize Protection?

A chief risk officer or risk manager facing the above scenario might be extremely frustrated, to say the least; however, the insurance arguably operated as intended. The traditional A/B/C coverage included a mandatory priority-of-payments provision designed to maximize coverage for individual directors and officers even when detrimental to the corporate balance sheet. The priority-of-payments provision offered valuable protection to individual directors and officers against corporate dilution of limits and corporate bankruptcy risk. Had the entire loss been non-indemnifiable, the full \$150 million of insurance limits would have been available to respond on behalf of any individually named directors and officers. Nevertheless, explaining the nuances of indemnifiable and non-indemnifiable loss and/or a D&O priority-of-payments provision to the GC, CFO, or CEO only after incurring a \$25 million uninsured loss is certainly no happy place for a risk manager. So, what can a risk manager do to mitigate the risk of suffering such a surprising result?

1. Seek coverage advice early in the claim process and well in advance of resolution.
 - Employ a focused strategy, seeking global settlement within your traditional A/B/C D&O limits where feasible, leaving Side A-only limits as a source of payment of last resort.
 - Pay close attention to the timing of claims settlement, particularly as respects insurer reimbursement

of indemnifiable versus non-indemnifiable matters.

- Seek advance carrier consent as to settlement terms and as to each carrier's respective funding of settlement amounts.
2. During the underwriting process, carefully evaluate your priority-of-payments wording and explore the alternatives.
- Completely understand how your priority-of-payments provision will be applied. Priority wording varies from carrier to carrier in terms of whether Side A priority is mandatory or discretionary, as well as to the timing of when the priority applies. Keep in mind that granting priority to Side A-only non-indemnifiable loss affords substantial comfort to your individual insureds against a corporate claim or bankruptcy that exhausts or otherwise limits the individual D&O insurance protection. In the absence of priority-of-payments wording, or where such wording grants discretion to the company as to whether to invoke the priority, individual directors and officers are at further risk of suffering an uninsured loss.
 - Is the priority wording absolute, and if so, how would the wording affect a settlement that may involve both indemnifiable and non-indemnifiable claims? If your wording is discretionary, or otherwise allows the carrier to withhold payment in certain instances, determine the individual or individuals who may invoke the priority, and give thought to formalizing a process for evaluating the decision and any potential conflicts of interest.
 - Should consideration be given to eliminating or imposing further conditions to the priority language? In light of the concerns noted above regarding corporate exhaustion of policy limits or bankruptcy risk associated with seizing corporate assets, it is not likely under most circumstances that modifying the wording would be advisable. Nevertheless, if your company maintains Side A-only DIC limits sufficient to resolve most if not all potential non-indemnifiable loss exposure, an argument could be made in support of eliminating absolute Side A priority in the traditional program and/or modifying the wording so as to grant Side A non-indemnifiable loss priority solely in the context of financial insolvency.
 - Consider negotiating express wording in the Side A-only DIC policy clarifying that, while it provides coverage solely for Side A loss, it does not follow the underlying policy's priority-of-payments wording. The Side A DIC insurer would be prevented from avoiding an otherwise

covered claim based solely on an order-of-payments provision contained in the underlying insurance. Some insurers may refuse modification, but the Side A DIC market remains highly competitive.

3. Make sure you have the proper D&O limits in place.

- At some level, the above example highlights the importance of making sure that you have appropriate D&O insurance limits in place. The company involved may have thought \$150 million of insurance was adequate, but hindsight revealed a \$25 million shortfall in indemnifiable coverage.
- Some might advocate that insureds purchase completely separate Side A and B-C towers with excess Side A DIC coverage on top of the Side A-only tower (or with a complete Side A-only DIC tower), thus, avoiding the priority-of-payments issue entirely. Of course, this approach is the most costly alternative and still does not solve the issue of unused or inefficient use of the insurance program.

If you first understand your priorities for purchasing D&O coverage and then order your priorities consistent with that approach, you will maximize your insurance recovery in the context of a claim. In most cases, companies will likely decide it is not necessary to change anything about their respective programs or limits; however, the discussion will be a great opportunity to get all interests aligned and eliminate future surprises. Informed priorities should be the cornerstone of any prudent risk-management and litigation-management architecture. ✱

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Responding to Subpoenas from Federal Agencies: Does FRE 502(d) Provide the Means to Protect Privilege?

By Laura D. Cullison

Practitioners looking for a way to produce documents to a federal agency such as the Securities and Exchange Commission (SEC) while maintaining privilege may find a glimmer of light in Federal Rule of Evidence 502(d). (While the rule discusses both attorney-client privilege and work product, the term “privilege” is used within this article for brevity.) Under Rule 502(a), in a federal proceeding or in a production to a federal agency, any intentional privilege waiver generally is limited to the actual communications or information produced. Under Rule 502(b), inadvertent disclosure will not waive the privilege, as long as the holder of the privilege takes reasonable steps to prevent disclosure and acts promptly to retrieve the inadvertently disclosed documents. Rule 502 was a disappointment for those who had hoped for a rule that would also codify selective waiver: the doctrine (supported by a minority of courts) that the intentional production of privileged documents to a federal agency, such as the SEC, does not act as a waiver of the privilege in other proceedings.

Rule 502(d)

Although the drafters of Rule 502 rejected selective waiver, they included section d within Rule 502, a provision that provides a different means of protecting privileged materials. This section of the rule has been described by some as the most innovative, far-reaching, and novel aspect of Rule 502.

Rule 502(d) states:

A Federal court may order that the privilege or protection is not waived by disclosure connected with the litigation pending before the court—in which event the disclosure is also not a waiver in any other Federal or State proceeding.

As a procedural matter, Rule 502(d) only speaks to litigation “pending before the court.” This would seem to indicate that the drafters did not intend for Rule 502(d) to be applied in actions involving subpoenas issued by federal agencies. However, Judge Shira A. Scheindlin recently suggested in her remarks at a Practising Law Institute on “Current Issues in Electronic Discovery,” held on December 4, 2009, that if the recipient of the subpoena files a

motion to quash the subpoena in federal court, that would create litigation pending before the court and satisfy Rule 502(d). This procedure also avoids the problems raised by a declaratory judgment action. Admittedly, filing a motion to quash raises the separate question of whether the recipient of the subpoena is willing to air the matter in a federal court proceeding. However, absent this step, Rule 502(d) cannot be applied to documents produced in response to a subpoena from a federal agency. This limitation is reinforced in the notes to section d, which state: “[t]he rule provides that when a confidentiality order governing the consequences of disclosure in that case is entered in a federal proceeding, its terms are enforceable against non-parties in any federal or state proceeding.”

In theory, to receive the protection of Rule 502(d), the party who receives a subpoena would move to quash the subpoena, and for the court to enter an order pursuant to Rule 502(d) that privilege is not waived by disclosure of the documents requested in the subpoena. This potential procedure is possible because Rule 502(d), on its face, is not limited to inadvertent disclosures. The inclusion of intentional disclosures in Rule 502(d) is further reflected in the notes to section d, which specifically approve the intentional production of privileged documents under “claw-back” or “quick-peek” agreements that forego privilege review altogether:

the rule contemplates enforcement of “claw-back” and “quick peek” arrangements as a way to avoid the excessive costs of pre-production review for privilege and work product. *See Zubulake v. UBS Warburg LLC*, 216 F.R.D. 280, 290 (S.D.N.Y. 2003) (noting that parties may enter into “so-called ‘claw-back’ agreements that allow the parties to forego privilege review altogether in favor of an agreement to return inadvertently produced privilege documents”).

Rule 502(d) thus allows for the disclosure of privileged materials, without waiver of privilege in the immediate proceeding or any other federal or state proceeding, if the disclosure is pursuant to court order under Rule 502(d). Such an order can arise by agreement of the parties, but, per the notes, “a confidentiality order is enforceable whether or not it memorializes an agreement among the parties to the litigation.” Agreement of

the parties “should not be a condition of enforceability of a federal court’s order.”

This scenario creates the possibility that a privileged document produced in response to an SEC subpoena, subject to a Rule 502(d) order, would be protected from waiver. Moreover, under a claw-back or quick-peek agreement, the privilege is not selectively waived. Rather, via court order, the issue of privilege is put on hold to facilitate the exchange of materials. The questions raised by this

suggested approach do not have definitive answers yet, in part because early decisions by the courts are not consistent in their approach to Rule 502(d).

Early Court Decisions

One court, in granting a motion to compel production of a large group of emails, rejected the suggestion that the emails be produced under Rule 502 pursuant to a non-waiver or quick-peek agreement.¹ The court observed:

The difficulty with [the quick-peek proposal] is that

Rule 502(b) preserves the privilege if “the holder of the privilege or protection took reasonable steps to prevent disclosure” of the privileged material. Simply turning over all ESI materials does not show that a party has taken “the reasonable steps” to prevent disclosure of its privileged materials . . .²

Some commentators have viewed the court’s rejection of a quick peek to confirm the view that Rule 502, including Rule 502(d), only prevents waiver when the disclosure of privileged materials is inadvertent. That is, the privileged material would not have been produced had the party properly identified the material during its privilege review. However, the notes clearly contemplate quick-peek situations where there is no privilege review at all, and yet the privilege is maintained. Perhaps a better way to address this issue is to recognize that, if the court orders the quick peek under Rule 502(d), then any production of privileged materials within the quick peek is inadvertent because the quick peek is court-ordered and not voluntary.

In contrast to the *Spieker* court’s limited interpretation of Rule 502, another court expansively invoked the non-waiver protections of Rule 502(d) to overcome the

defendant’s request for a stay in *Whitaker Chalk Swindle & Sawyer, LLP v. Dart Oil and Gas Corp.*,³ In this case, the defendant argued that, without a stay, it would be required to turn over documents that would result in a waiver of privilege in other Texas state-court proceedings. The court disagreed, finding that it was “within this Court’s authority to order discovery to proceed” pursuant to an order under Rule 502(d), and that under such order the defendant “has not waived the attorney-client or work-product privilege.”⁴ The court in particular noted that it could not find “any reason why a Texas court would not recognize an order entered under Rule 502.” Rule 502 clearly states that Rule 502(d) orders are effective in federal and state proceedings; however, whether state courts will find any impediment to recognizing a Rule 502(d) order is an unresolved question.⁵

Another recent Rule 502(d) order of note is the October 14, 2009, order entered by the Southern District of New York in *SEC v. Bank of America Corp.* This much-publicized case concerns, in part, legal advice regarding the disclosures in proxy statements about the merger between Bank of America and Merrill Lynch. The parties in the case created a “Disclosure Stipulation Agreement and Proposed Protective Order” wherein Bank of America agreed to waive the privilege as to certain categories of documents being voluntarily produced to the SEC “while not waiving the privilege with respect to any additional documents.”⁶ The court entered the proposed agreement under Rule 502(d) as a means of protecting Bank of America “against any claim that the stipulated waiver here attached implicitly effectuates a broader waiver.” This Rule 502(d) order does not involve a quick peek, but instead takes the parties’ confidentiality agreement and applies its terms to other federal and state proceedings. This decision has been subject to criticism for overreaching the plain language of Rule 502. As some commentators have described the decision, the parties used Rule 502(d) to create their own selective waiver, when the drafters of Rule 502 specifically rejected selective waiver. However, others have suggested that the court’s order simply ensured that the protections found in Rule 502(a), regarding subject-matter waiver, would apply in any other proceedings. All agree that the actual impact of the court’s Rule 502(d) order remains to be seen.

Rule 502(d) Benefits Both Sides

Employing Rule 502(d) when producing documents to a federal agency is consistent with the goals of Rule 502, as stated in the notes, to provide a “predictable, uniform set of standards under which parties can determine the consequences of a disclosure of a communication.” Moreover, both private litigants and federal agencies have reasons to

When companies are harmed in later litigation by sharing privileged information with the SEC, cooperation dries up.

support Rule 502(d). For example, in the case of an SEC subpoena, if the company provides information quickly, it shows a high level of cooperation. For the SEC staff, having early access to information, including privileged information, allows them to efficiently evaluate the issues and determine the appropriate regulatory response. Also, the company may save thousands or even millions of dollars in production and litigation costs by providing the staff with up-front information that could streamline the investigation.

The company's desire to protect the privilege in other proceedings is obvious. The SEC, however, also shares an interest in maintaining the privilege. The staff wants companies to quickly and efficiently provide information. When companies are harmed in subsequent litigation by sharing privileged information with the SEC, cooperation dries up. When cooperation dries up, it is harder for the SEC to do its job. The SEC recently recognized the benefits of cooperation regarding the *Bank of America* case: "Bank of America waived all claims of privilege relating to the proxy disclosures made in connection with the merger and several other subjects in order to permit the SEC to conduct a thorough investigation of these subjects . . ." Under Rule 502(d), however, it may

be possible for the SEC to investigate thoroughly *and* for the company to maintain the privilege.

Whether the glimmer of light in Rule 502(d) is substance or illusion remains to be seen, but this provision definitely provides the opportunity for novel approaches to maintaining privilege. ✱

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1. *Spieker v. Quest Cherokee, LLC*, 2009 WL 2168892 (D. Kan. July 21, 2009).
2. *Spieker*, 2009 WL 2168892, *9.
3. 2009 WL 464989 (N.D. Tex. Feb. 23, 2009).
4. *Whitaker*, 2009 WL 464989, *8.
5. See Noyes, Henry S., *Federal Rule of Evidence 502: Stirring the State Law of Privilege and Professional Responsibility with a Federal Stick*, 66 WASH. & LEE L. REV. 673 (2009) (arguing that Rule 502's application to state court proceedings is unconstitutional).
6. *SEC v. Bank of Am. Corp.*, 09 Civ 6829, (S.D. N.Y. Oct. 14, 2009).
7. Ex. Act. Litig. Rel. No. 21371 (Jan. 11, 2010).



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