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The Securities Class-and-Derivative Litigation Two-Step

By William S. Freeman

Your client, a publicly traded company, has just announced that it will miss its quarterly earnings forecast by a significant amount. You are attuned to the possibility of a class action complaint under section 10(b) of the Securities Exchange Act of 1934, in which it will be alleged that the company defrauded investors by “concealing” the “truth” for many months, only to “shock the market” with the announcement. You have prepared the company for this possibility, and you are disappointed but hardly surprised when the complaint is filed. You reassure the company that under the Private Securities Litigation Reform Act of 1995 (PSLRA), the plaintiff will have to meet an exacting pleading standard and will not be able to conduct any discovery until and unless your motion to dismiss is denied. You have a pretty good idea of

how the court will analyze that motion, since many of the key provisions of the PSLRA have now been interpreted.

The following week, however, a shareholder derivative complaint is filed in superior court, naming all of the company’s directors and alleging that they breached their fiduciary duties by permitting the company to publish false information. The allegations concerning the underlying wrongdoing appear to have been lifted word-for-word from the federal complaint, but this new lawsuit is beyond the reach of the PSLRA’s procedural safeguards, and it will unfold in a forum in which most judges have had less exposure to these cases. You quickly discover that there are no reported decisions in California that explicitly address this type of suit.

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ERISA Stock Drop Pleading Motions

By Christopher J. Rillo

Over the past three years, the plaintiffs’ class action bar has discovered that ERISA with its common law trust antecedents can be used to address securities law claims.¹ Eligible individual account plans often feature the plan sponsor’s common stock as either a permitted investment or a corporate contribution. Such funds are extremely popular investment plans. Some experts estimate that at least 19% of all 401(k) assets are invested in employer stock and that 2,000 companies feature company stock in their plans.² Due to tax code changes enacted in 2001, many of these 401(k) plans are also designated as an ESOP. When an employer’s stock declines in value and there are some indicia of a securities violation, the class action bar has filed ERISA-based complaints that typically charge a wide variety of defendants with breach of fiduciary duty. As there are only two reported appellate decisions addressing these claims³ and only one known trial of a stock drop case as of November 2004⁴, these claims raise unique litigation challenges. These cases were

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The securities litigation two-step—a federal class action followed closely by a remarkably similar state derivative complaint—is now commonplace. The shareholder derivative suit, a tool traditionally used to attack alleged insider corruption or questionable corporate transactions, is now routinely used as an alternative means to pursue claims of misleading corporate disclosure.

A compelling case can be made that the use of derivative suits to pursue corporate open-market disclosure claims is a fundamental perversion of the derivative device. While that argument should be made, defense counsel also must deal with immediate questions of strategy and tactics. Handling these cases effectively requires careful footwork, complex conflict-of-interest analysis, thoughtful advice, and long-range strategic planning. While attempting to shape the emerging law in state court, counsel must also focus on day-to-day decisions, anticipating multiple possible outcomes at every stage of the litigation, and staying several moves ahead of the game.

How Did We Get Here?

To understand the dynamics of the current situation, it is necessary to review the recent history of the securities class action wars.

A dozen years ago, it seemed that every time a public company announced disappointing news, it was immediately hit with a rash of class action fraud suits under section 10(b) of the Exchange Act. In response to public outcry over perceived litigation abuses, in 1995 Congress enacted the PSLRA, which, among other things, set forth exacting pleading requirements and imposed an automatic discovery stay until a complaint had survived a motion to dismiss.

The PSLRA did in fact lead to an increased success rate for defendants in motions to dismiss. In response, plaintiffs' counsel sought to avoid the PSLRA altogether by filing class actions in state courts under state securities laws, where they hoped to take advantage of more lenient pleading requirements and immediate discovery. Congress thwarted that tactic in 1998 by enacting the Securities Litigation Uniform Standards Act (SLUSA), which provided that most shareholder class actions must be litigated in federal court under the federal securities laws. SLUSA, however, contained a loophole: it provided that shareholder derivative actions could continue to be litigated in state court. The significance of that loophole has been growing ever since.

Differences between Class Actions and Derivative Cases

Securities class and derivative actions are radically different both in theory and in practice. In a class action, the plaintiffs are shareholders seeking recovery of personal investment losses allegedly caused by misleading disclosure. A judgment or settlement results in a payment that is divided among the shareholders.

The derivative suit is also commenced by a shareholder, but the similarity with the class action ends there. The defendants may include the same officers and directors, but the

underlying plaintiff is the corporation itself; the suit is “derivative” because “the rights of the plaintiff shareholders derive from the primary corporate right to redress the wrongs against it.” *Desaigoudar v. Meyercord*, 108 Cal.App.4th 173, 183 (2003). (Whether the company has in fact been damaged by the alleged wrongs is highly debatable; plaintiffs resort to arguing that the company will have to spend money to defend the already-filed class action, and that its future ability to raise capital may be impaired.) In theory, at least, any monetary recovery goes not to shareholders, but to the corporate treasury.

Derivative suits have long been brought to contest proposed corporate transactions, generally on the theory that a deal was improperly conceived or structured for the benefit of corporate insiders, or that the directors breached their fiduciary duties by failing to maximize the price paid to shareholders. The use of the derivative suit to repackage class action claims that are already pending in federal court is both innovative and controversial. While it can be expected that California courts will eventually develop a uniform body of law concerning these cases, for now the frontier is largely unregulated, and defense counsel must adapt accordingly.

The Demand Requirement and Plaintiffs' Attempts to Avoid It

The derivative suit is an exception to the rule that the corporation, acting through its board, has the sole right and power to sue for redress of injuries to the corporation. *Burks v. Lasker*, 449 U.S. 471, 487 (1979) (concurring opinion of Stewart, J.). It is, in essence, an attempt to wrest from the board a key mechanism of corporate governance. Both Delaware and California have statutory safeguards to prevent this seizure of power from being routinely or easily accomplished. To establish standing to bring a derivative action, a plaintiff must either make demand on the board that it institute the action itself, or allege “with particularity” her reasons for not doing so. Del. Chancery Ct. R. 23.1; Cal. Corp. Code section 800(b)(2). The presuit demand requirement is rooted in legislative policy discouraging judicial interference with corporate decision making. *Shields v. Singleton*, 15 Cal.App.4th 1611, 1619 (1993), quoting 1A HENRY W. BALLANTINE & GRAHAM L. STERLING, CALIFORNIA CORPORATIONS LAW section 292.03, p. 14-19 (4th ed. 1992).

If the plaintiff makes pre-suit demand on the board and the board determines not to pursue the claim, that determination is accorded considerable deference by the court under the business judgment rule, and constitutes a defense to the suit. *Desaigoudar, supra*, 108 Cal.App.4th at 183-85; *Grimes v. DSC Communications Corp.*, 724 A.2d 561, 565 (Del. Ch. 1998). Perhaps for this reason, plaintiffs routinely attempt to avoid the presuit demand requirement.

Instead, plaintiffs allege that demand is “excused” because it would be “futile.” The claim of “demand futility” is based on boilerplate allegations that could be made with equal force against any company’s board: that since the plaintiff has named all directors as defendants, they cannot be expected impartially to consider suing themselves; that direc-

tors “dominate” or “control” each other; and/or that a derivative claim will not seriously be considered because it might not be covered under the company’s directors and officers insurance policy.

In both California and Delaware, the demand futility pleading requirements are stringent. Conclusory allegations will not suffice; the plaintiff must allege specific facts as to each individual director that demonstrate the absence of a disinterested majority of directors who could consider a demand. *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993); *Oakland Raiders v. Nat’l Football League*, 93 Cal.App.4th 572, 587 (2001); *Shields, supra*, 15 Cal.App.4th at 1621-23. As a result, one would think that superior courts would uniformly dismiss complaints that employ boilerplate language and make generalized accusations that directors lack impartiality. The reality is that enforcement of these pleading strictures has, thus far, been inconsistent in the trial courts, and the California appellate courts have yet to issue definitive pronouncements about the use of derivative suits to advance claims of corporate nondisclosure. As a result, defense counsel must plan for a number of eventualities.

Managing Discovery in the Derivative Case

To defense attorneys accustomed to the PSLRA’s discovery stay, an early set of interrogatories or document requests in a derivative case may come as an unpleasant surprise. But defense counsel is not without weapons.

The first is a possible stay of discovery. On occasion, derivative plaintiff’s counsel may determine, for strategic reasons of his own, that a stay would be useful, either to permit the two actions to proceed in tandem if the federal motion to dismiss is denied, or just to avoid the burden of “going it alone” at the early stages. If counsel is not interested in a voluntary stay, there is a basis to seek a stay in federal court. The PSLRA provides that “upon a proper showing,” the federal court in which the class action is pending may order a stay of discovery in the derivative suit “as necessary in aid of its jurisdiction. . . .” 15 U.S.C. § 78u-4(b)(3)(D). If it appears that the discovery is being sought in the derivative case for the purpose of evading the federal discovery stay, defense counsel should seriously consider moving for such a stay. (At the very least, counsel should be able to persuade the derivative plaintiff’s attorneys to agree not to share discovery with the class plaintiff’s counsel.) Another possible basis for a stay is that until the demand futility demurrer is overruled, the plaintiff has not established that she has standing to sue, and therefore should not be permitted to take discovery.

Even if a complete stay is not obtained, you can still negotiate, or apply for an order, for staged discovery in the state court—limited initially to demand futility-related issues. Counsel will often agree to restrict early discovery to information that bears directly on the reasons why board members could not evaluate a demand impartially, such as their economic relationships with the company or their financial and personal relationships with each other.

If the case survives demurrer, every effort should be made to manage the discovery process to minimize the burden on the company. Whether this leads counsel to seek a volun-

tary or involuntary stay of “merits” discovery will depend on, among other factors, the similarity of the allegations in the two cases, the pendency of an internal investigation by the company, and the relative stages of the two cases. All other things being equal, it is hard to imagine that conducting discovery twice would be in anyone’s interest.

Motion to Stay Pending Internal Investigation

Because the derivative case implicates corporate governance issues, the defense has available to it a tactic unknown to the securities class action: a motion to dismiss based on a board determination that the continued maintenance of the action is not in the best interest of the company.

If the complaint survives demurrer, the company can appoint a disinterested committee to investigate the complaint’s allegations and consider whether continued litigation is in the corporation’s best interest. If a determination is made that it is not, the company can move to dismiss the complaint. This motion takes on some characteristics of a summary judgment motion, with the court focusing on the investigative process underlying the committee’s determination.

Desaigouadar, supra, 108 Cal.App.4th at 184-90. The most defensible decisions are made only after a thorough investigation by a disinterested committee.

The determination of whether and how the company should undertake such an investigation is complex and highly individualized.

It is easiest to make this decision if the board has been properly advised from the outset as to its strategic options in the event the demand futility demurrer is overruled.

Potential Conflicts of Interest

Multiparty representations typically raise potential conflicts of interest, since it is conceivable that the clients’ interests, even if unified at the outset, could diverge down the road. Parallel derivative and class action litigation multiplies the number of conflicts that must be considered under California Rule of Professional Conduct 3-310(C). As with all questions of conflicts of interest, any waiver must be given in writing, upon disclosure of the relevant facts and a discussion of “the actual and reasonably foreseeable adverse consequences to the client” of the potential or actual conflict. *Id.*, Rule 3-310(A).

The analysis of conflicts in any particular situation is beyond the scope of this article. The analysis will be highly fact-specific, and the resolution will depend in part, as it should, on client preferences. It is essential, however, that the possible procedural twists and turns of a derivative case be thought through in advance, so that defense counsel can educate their clients concerning the issues they will have to consider at each stage of the proceedings.

Defense can file to dismiss if the board determines that continuing could hurt the company.

When a company and individual officers or directors are faced solely with a class action, it is not uncommon for defense counsel to represent all defendants jointly throughout the case. In the class-derivative two-step scenario, however, matters get far more complicated. To begin with, counsel is confronted by the fact that the corporation, while procedurally aligned with the individuals as a defendant in the class action, is technically aligned (albeit against its will) against them as a putative plaintiff in the derivative suit.

Initially, the company and the individuals share a common interest in having the suit dismissed, although for different reasons. The individuals seek to defeat any claim of personal liability; the company has a powerful interest in thwarting the attempted hijacking of its power to initiate litigation.

The situation gets more complex in the event the "demand futility" demurrer is overruled. The company now has three strategic options. First, it can take a back seat, allowing the plaintiff to proceed with the litigation on its behalf while seeking to protect its personnel from procedural abuse. Second, it can decide to seek a stay of the litigation to conduct its own investigation through a special litigation committee of the board. If that investigation concludes that the suit is meritless, the company can then move for dismissal. Third, it can enter into settlement discus-

sions, also under the supervision of a special committee. Each of these alternatives raises representation issues requiring full consideration.

Case law regarding conflicts of interest in derivative cases is neither well developed nor clear. What is clear, however, is that defense counsel must think carefully at the outset about the possible paths a derivative case can take, and how the interests of the clients can best be served.

Conclusion

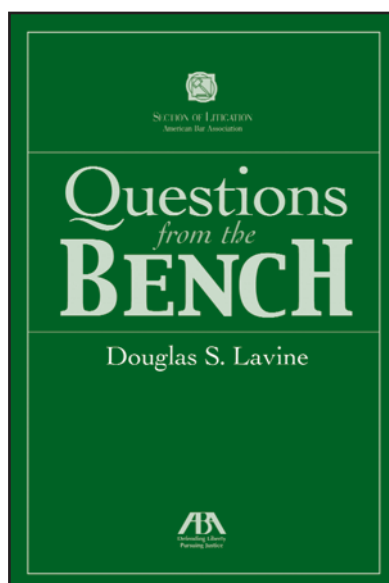
The recent emergence of the derivative action as a tool to pursue corporate disclosure claims is an unintended consequence of the effectiveness of the PSLRA, and it may well be a misuse of the derivative device. In contrast to the PSLRA, the law applicable to state law derivative actions is still developing and clear guideposts have yet to emerge. At least until the courts or the legislature resolve the doctrinal and policy issues raised by these cases, defendants and their counsel must learn to master the class-and-derivative litigation two-step. *

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ERISA Stock Drop

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undoubtedly never contemplated when Congress passed ERISA 30 years ago and the case law is still evolving.

These actions, which number over 50⁵ as of November 2004, fit a basic pattern. All complaints allege that the company established an individual account defined contribution plan, featuring company stock as an investment option, and that participants suffered losses because the company stock declined, often as the result of some purported wrongdoing by the company or insiders. In addition, all actions allege that defendants breached their ERISA fiduciary duties purportedly owed to participants for several reasons. Plaintiffs assert one or more of these contentions: (1) corporate insiders failed to provide adequate information, including accurate financials, to participants;⁶ (2) corporate insiders acted imprudently, failing to close company stock as an investment option or failing to divest the plan of company stock;⁷ (3) corporate insiders acted imprudently in offering company stock as an investment option in the first place;⁸ (4) corporate insiders labored under a conflict of interest and violated their duties by failing to retain an independent fiduciary;⁹ (5) corporate insiders improperly encouraged participants to invest in company stock, knowing it was a bad investment;¹⁰ (6) corporate insiders breached their duties by failing to disclose to participants material inside information regarding the company;¹¹ (7) corporate insiders failed to disclose illegal business practices at the company, which devalued the stock;¹² (8) corporate insiders breached their duties by trading for their own accounts based upon inside information;¹³ and (9) corporate insiders breached their fiduciary duties when they froze company stock as an investment alternative or froze further investments of company stock.¹⁴ Basically, these claims can be reduced to three categories: (1) prudence; (2) disclosure; and (3) failure to monitor or cofiduciary breach.

While some commentators predicted that ERISA stock drop actions were tied to the 2000-2002 downturn and would dissipate when the market recovered, these lawsuits appear to have become a permanent feature in the securities litigation landscape. This article analyzes defense strategies for pleading motions against these actions.

Plan Structures

As a threshold matter, this litigation focuses on defined contribution plans.¹⁵ Specifically, these actions involve participant-directed eligible individual account plans (EIAP). An EIAP is a profit sharing, stock bonus, thrift or savings plan, or employee stock ownership plan that explicitly provides for the acquisition and holding of stock issued by the plan sponsor.¹⁶

When Congress passed ERISA, it granted special treatment to EIAPs.¹⁷ Unlike other ERISA plans, an EIAP may acquire and hold large amounts of company stock and is not subject to any specific statutory diversification requirement. Moreover, the tax code encourages the use of employer stock to fund such plans.¹⁸ These twin concepts are important to this litigation.

To establish any plan, an employer must take some elementary steps. Every ERISA plan must have a sponsor,¹⁹ which is not a fiduciary function, and a named fiduciary that administers the plan.²⁰ Fiduciaries must act solely in the interest of plan beneficiaries and participants and must discharge their duties “with the care, skill, provider and diligence” of a “prudent man acting in a like capacity and familiar with such matters. . . .”²¹ Fiduciaries are also charged with administering the plan in accordance with its documents to the extent those are consistent with ERISA.²² In addition, plan documents must establish every plan.²³ The plan documents often prove key in this type of litigation. Normally an employer sponsors the plan and adopts the plan documents. These documents typically delegate to the board of directors or a board committee the responsibility for appointing and removing administrators, either a committee or an individual. Sometimes, the employer retains the designated fiduciary role, which can present problems in defending these cases. In most cases, a plan committee, or several committees, are appointed to oversee the plan.²⁴

These actions often involve disputed claims over fiduciary status. Plaintiffs often allege that anyone remotely connected with the plan, including corporate directors and senior corporate officers, are ERISA fiduciaries. As discussed below, fiduciary status forms a necessary predicate for liability in these actions. Fiduciary status is a functional test under the statute, which is dependent upon a factual analysis of a party’s actual conduct.²⁵ Even for those not designated as fiduciaries, ERISA imposes fiduciary status if they undertake certain discretionary actions with respect to a plan or its assets.²⁶ Moreover, some courts have held that ERISA does not require a showing of discretion for individuals who handle plan assets.²⁷

As mentioned above, a plan sponsor usually delegates its fiduciary responsibility to the board and an administrative committee. The directors on the board or the board committee charged with appointing and removing the fiduciaries, however, enjoy limited fiduciary status under both DOL regulations and the case law.²⁸ ERISA has both general and limited fiduciaries; a limited fiduciary is charged with fiduciary responsibility only over those activities for which he is responsible.²⁹ Before this litigation, such status was recognized and courts generally held that a plaintiff was required to plead and demonstrate causation against a limited fiduciary, that is, plaintiff’s harm resulted from the limited fiduciaries breach of her actual ERISA duty.³⁰

In contrast, the administrative committee and its individual members are general ERISA fiduciaries. As general ERISA fiduciaries, they are charged with the highest care when exercising an actual fiduciary duty on behalf of the plan.³¹ The Supreme Court has recognized the so-called “two-hat rule” that recognizes that corporate officers often serve as ERISA fiduciaries and that ERISA fiduciary obligations are imposed only when they actually perform a function on behalf of the plan.³² Unlike its common law trust

antecedents, ERISA contemplated that corporate officers would serve as fiduciaries and that their interests in exercising a corporate duty might raise conflicts with participants. ERISA permits corporate officers to serve as plan fiduciaries and allows certain conflicts of interest, so long as they do not involve transactions with plan assets or are otherwise specifically prohibited by the statute.³³ For example, an employer may serve as a fiduciary and also act in its capacity as a settlor, to modify the plan and to reduce the level of benefits to participants.³⁴

Plaintiffs' Allegations Generally Fit a Paradigm

ERISA stock drop cases often accompany securities fraud actions. There are two lines of cases that have developed in this area. First, there are the corporate fraud transactions exemplified by the notorious Enron Corporation and other corporate scandals of the postdot-com era, where the issuers are in bankruptcy and the securities have become worthless.

Plaintiffs often sue everyone; winnow it down to fiduciaries, limiting the action to ERISA claims.

These cases involve allegations of egregious fraud by corporate insiders. Perhaps not surprisingly, courts have more willingly expanded ERISA concepts in these cases in order to provide some recovery to injured participants.³⁵ Second, there are the garden-variety stock drop cases, where the plan's stock fund has lost value because of a decline in the company's market capitalization.³⁶ These cases typically raise more negligence-based allegations of general breach of fiduciary duty, including lack of prudence or diligence.³⁷ Although some courts have refused to distinguish between these two cases,³⁸ many courts recognize that more

deference should be given to fiduciaries where there are no allegations involving fraud.³⁹

The complaints are almost invariably styled as class actions where a participant is suing on behalf of a class of representatives who sustained losses. Some cases are pleaded as derivative actions on behalf of the plan.⁴⁰ ERISA allows three types of claims that have different remedies. First, section 502(a)(1) authorizes a participant or beneficiary to file suit to recover benefits or to enforce rights under a plan.⁴¹ Second, section 502(a)(2) permits a beneficiary or fiduciary to file suit on behalf of a plan under section 409, which imposes personal liability on fiduciaries who breach their duties.⁴² Third, section 502(a)(3) is an omnibus provision, authorizing participants to sue either fiduciaries or parties in interest for individual relief.⁴³ Plaintiffs are limited to equitable relief under this provision.⁴⁴ Although plaintiffs have invoked all three theories, most cases are styled as 502(a)(2) claims.

Plaintiffs often use these theories interchangeably in their complaints to seek individual relief without specifying on which theory they are relying. Recovery issues increasingly

arise because the statutory scheme limits relief depending upon the statute.

In evaluating whether a new action is adequately pleaded, a defense attorney should take several steps. First, the defense attorney should chart out all defendants in the complaint and determine what precise factual allegations are made against each. Plaintiffs commonly sue everyone in sight and sometimes fail to make any factual allegations against a peripheral corporate officer. In order to impose liability, plaintiffs need to plead and prove that each defendant enjoyed fiduciary status. As discussed below, fiduciary pleading motions are one of the most frequently litigated pretrial motions.

Second, the defense attorney should obtain all plan documents including: the plan and all amendments, all summary plan descriptions (SPD) for a reasonable period surrounding the class period, board minutes discussing plan issues, including appointing or removing fiduciaries, fiduciary committee minutes and reports, fiduciary committee consultant reports and individual account statements and summaries of the plan. These documents help define fiduciary status and provide clarification of the fiduciaries' actual obligations under the plan. Plaintiffs' allegations often demand that the fiduciaries override or ignore plan documents. To a large extent, plan documents will shed light on whether these claims are viable.

Third, the defense attorney should chart out plaintiffs' damage theories, including whether plaintiffs seek plan relief as opposed to individual relief and if so, how they propose such relief be given. The relief sought is critical and individual relief (especially for money damages) may not be available.

Defense Pleading Motions

In these actions, plaintiffs typically name more defendants than necessary, such as every director and senior corporate officer, and plead non-ERISA claims. Defense counsel will want to winnow down the case to actual fiduciaries and move against extraneous claims, in an attempt to limit the action to ERISA claims. Defense counsel must consider whether the complaint's damage allegations are permissible under ERISA and if not, whether to move against the complaint on this basis. Basically, the goal is to straight-jacket the case to ERISA claims pleaded against actual fiduciaries, and to limit the factual record on which the case will be litigated.

For that reason, pleading motions are almost invariably filed against most stock drop complaints. Although there are over 20 reported and unreported decisions, courts have made inconsistent decisions with respect to defendants' pleading motions. Besides being inconsistent, these decisions are not always well written and often do not shed light on the statutory body of law. A few principles, however, have emerged from this murky case law.

The vast majority of federal courts have held that Rule 9(b) does not apply to ERISA stock drop complaints and that plaintiffs need only comply with Rule 8(a)'s limited requirements for pleading.⁴⁵ For Rule 9(b) motions, some courts have distinguished between claims based upon "prudence" as opposed to claims that assert fraud, such as participation in

the fraud.⁴⁶ Courts uniformly have rejected motions to dismiss actions because the plan in question was a section 404(c) plan.⁴⁷ In addition, courts have been mostly unsympathetic to claims that securities prohibitions against insider trading prohibited disclosure of any additional information beyond that disseminated to other public shareholders.⁴⁸

Courts have given inconsistent treatment to motions to dismiss defendants on the grounds that plaintiffs have insufficiently pleaded fiduciary status. There is a growing trend in the decisions, which simply accept plaintiffs' allegations as factual claims that cannot be controverted on a Rule 12(b)(6) motion.⁴⁹

Motions to Dismiss Parties on Ground That Defendants Lack Fiduciary Status

The most common pleading motions are motions challenging defendants' fiduciary status. As mentioned above, ERISA prescribes a functional test for fiduciary status. The definition is "functional," meaning that one is a fiduciary if, and only to the extent, she is performing a function described in section 3(21)(A).⁵⁰ These defense pleading motions can prove problematic because courts historically have regarded fiduciary status as a mixed question of law and fact.⁵¹

Some prestock drop decisions required a plaintiff to plead affirmatively factual allegations sufficient to establish each defendant's fiduciary status.⁵² To be sure, some stock drop decisions have adopted this view, granting motions to dismiss where plaintiffs have failed to plead such facts⁵³ or where plaintiffs have lumped all defendants together without specifying what facts support each one's fiduciary status.⁵⁴ The issue is often whether plaintiffs must plead more factual content beyond parroting the words of the statute, by alleging, for example, how a particular corporate officer asserted control over plan assets or undertook discretionary actions with respect to the plan. There has been a trend towards accepting such bare-boned allegations, holding that they are sufficiently factual to pass muster under Rule 12. Given that prior case law uniformly required some factual detail to support a charge of fiduciary status, which carries with it the knife of personal liability, the better view is to require plaintiffs to plead more facts rather than simply repeating the vaguely worded verbiage of the statute.

Plan Sponsors

Plaintiffs' counsel often sue the plan sponsor on the grounds that it is a fiduciary. Especially in a nonbankruptcy case, plaintiffs' counsel frequently seek to assert fiduciary claims against plan sponsors, probably because fiduciary policy limits are wasting. While it should be easy to determine whether a company is a fiduciary based upon the plan documents, courts have found these issues difficult, at least at a pleading stage. However, a few courts have readily dismissed plan sponsors.⁵⁵ Plaintiffs commonly label sponsors as fiduciaries based upon the fact that it employs the fiduciaries and other parties who implement the actions at question. Such theories are problematic for two independent reasons.

First, under *NLRB v. Amax Coal*,⁵⁶ the Supreme Court held over 20 years ago that where an employee is acting in a

fiduciary capacity, that employee is never acting as an employer agent or fiduciary. *Amax Coal* involved a bargaining dispute over whether a surface mine would be a member of a multiemployer trust fund. *Amax* charged that union's pension trustees were representatives of the union, in connection with the labor dispute, and that its actions, taken in a fiduciary capacity, constituted an unfair labor practice. The Supreme Court rejected this argument, holding that as a matter of law, the union did not control trustees' actions undertaken in their fiduciary capacity.⁵⁷ Under *Amax*, a plan sponsor cannot be vicariously liable for a plan fiduciaries' actions that were undertaken in a fiduciary capacity.

Second, the settlor doctrine undercuts these claims, at least to the extent that they seek to attack a plan sponsor for decisions made in a settlor capacity. Decisions regarding the structure of the plan, amendment of the plan, or funding of the plan historically have been regarded as settlor decisions.⁵⁸ As noted earlier, settlor actions are not undertaken in a fiduciary capacity.

While some courts readily have dismissed sponsors, other courts have wavered over these issues. Confronted with this seeming bulwark of law, plaintiffs' have adopted chameleon-like theories to dodge defense pleading motions. While acknowledging the settlor doctrine, plaintiffs still argue that plan sponsors have liability for cofiduciary breaches or as parties-in-interest who conspired with fiduciaries. The latter argument borders upon a non sequitor under the statute. Since *Mertens*, it remains questionable whether non-fiduciaries can be held liable for a fiduciary breach, and it is clear that the sole remedy is equitable, a nonremedy in a stock drop action against a plan sponsor. Courts have confused the issue, refusing to hold a sponsor liable because of the settlor doctrine, but leaving open cofiduciary or respondeat superior liability.⁵⁹

Directors

On motions to dismiss directors, courts have split on the standards necessary to plead fiduciary status. As noted above, directors charged with the authority to appoint or remove directors constitute limited ERISA fiduciaries. Plaintiffs often allege that these defendants are general ERISA fiduciaries or fail to label them as limited fiduciaries. Some complaints acknowledge that directors have limited fiduciary status but allege that liability for all fiduciary breaches. Others acknowledge that director-defendants' duties were limited to appointment and removal of fiduciaries, but then fail to plead that plaintiffs' harm was caused by the breach of this limited duty.

In three early reported stock drop decisions, three district courts granted motions to dismiss directors on the grounds that plaintiffs' complaints failed to allege sufficiently that breach of directors' limited fiduciary duty cause plaintiffs any harm.⁶⁰ All three courts held that plaintiffs needed to demonstrate causation as a matter of pleading, that is a nexus between the directors' breach of their limited duty and plaintiffs' injury. These holdings are congruent with ERISA as they flow directly from the concept that fiduciary status may be limited and that corporate officers may wear "two hats" when acting as ERISA fiduciaries.

ERISA recognizes limited fiduciaries as well as general ones. Where a party is a limited fiduciary, one is required to prove that the breach of his limited duty caused the injury. In nonstock drop cases, courts have dismissed claims against limited fiduciaries where plaintiffs cannot demonstrate such causation.⁶¹

The Supreme Court in *Pegram v. Herdrich*,⁶² reaffirmed the so-called “two-hat” rule which provides that a corporate officer who also is an ERISA fiduciary is only liable under ERISA if she violates her fiduciary duty while she is performing a fiduciary function or acting in a fiduciary capacity. Although ERISA has some of its antecedents in common law trust law, which requires absolute loyalty from trustees, Congress recognized that employers and corporate officers will often act as employers and plan fiduciaries. Because employers are charged with day-to-day affairs in running a business, ERISA’s drafters acknowledged that it would be counterproductive to prohibit each and every conflict of interest that could arise between an employer’s interests and those of plan participants. If ERISA provided otherwise, corporate employees would be disqualified from serving as fiduciaries and plan administrative costs would drastically increase. Therefore, so long as fiduciaries do not perform any fiduciary functions, deal in plan assets or commit a prohibited transaction, ERISA anticipates and allows their divided loyalties.⁶³ The two-hat rule articulates these concepts and simply holds that when an employer is performing a corporate function, he is not liable under ERISA for breach of fiduciary duty.⁶⁴

Some courts have permitted defendants to raise the two-hat concept on a pleading motion,⁶⁵ but most courts have been hostile to motions to dismiss corporate directors and officers on this basis.⁶⁶ These rulings are consistent with the framework of Rule 12. In essence, the two-hat concept calls for an examination of defendant’s contention that she was performing a corporate as opposed to a fiduciary function when she undertook the action in question. In most instances, the defense necessarily contradicts a factual allegation of the complaint.

Corporate Officers

Plaintiffs often sue senior corporate officers, perhaps because such officers are named as defendants either as primary defendants or as controlling persons in parallel securities complaints. Plaintiffs allege that such officers performed a discretionary function under the statute, which transformed their role into fiduciaries. Unless designated as fiduciaries or transacting in plan assets, most corporate officers should not be regarded as ERISA fiduciaries.⁶⁷ Despite recognizing that principle, most courts have been reluctant to dismiss officers on the grounds that plaintiffs have failed to plead adequately fiduciary status in stock drop cases.

The case law denying motions to dismiss corporate officers draws its support from the fraud cases.⁶⁸ In *Enron*, the Department of Labor’s (DOL) amicus brief advocated, for perhaps the first time, the concept that corporate officers who participated in corporate securities fraud were personally liable under ERISA if the issuer retained its fiduciary status.⁶⁹ To some extent, *Enron* is a testament to questionable

plan documentation. In *Enron*, the designated fiduciary was the corporation. Enron did not delegate its fiduciary duties to the board and acted through its board and corporate officers. The *Enron* court adopted the DOL’s view, holding that plaintiffs’ claim that directors and corporate officers alleged failure to provide accurate information to the plan fiduciary committee constituted a violation of ERISA. Moreover, defendants were personally liable by reason of their actions for the corporation’s breach of fiduciary duty.⁷⁰

In *WorldCom*, the court illustrated these principles by distinguishing between Bernard Ebbers, WorldCom’s former chief executive officer, and other officers, holding that plaintiff’s allegations were insufficient against other officers, but sufficient against Ebbers.⁷¹ Plaintiffs’ pleadings, however, centered on Ebbers and Scott Sullivan, WorldCom’s former chief financial officer. Sullivan, who subsequently pleaded guilty to securities fraud and other charges, did not even move against the ERISA complaint. The other officers were simply alleged to be fiduciaries under the plan’s documents, which permitted any officer of WorldCom to act as a plan fiduciary in the event that the company failed to appoint fiduciaries.⁷²

The case law suggests that a fiduciary who commits fraud owes a higher duty of care to participants. Under the law of trusts, however, no principled basis distinguishes the scope of fiduciary duty in a company charged with fraud and a company accused of a mere lack of prudence. To state the obvious, fiduciaries, who are charged with the highest duty, are not supposed to commit fraud. Therefore, a fiduciary’s duties are not increased when he has engaged in fraud. These decisions, which appear to lower the fiduciary status bar for officers charged with fraud, may simply reflect the school of judicial realism, at least at a pleading stage.

Directed Trustees

A directed trustee invests plan assets based upon directions it receives from the named fiduciary, an investment manager or plan participants.⁷³ While directed trustees are limited ERISA fiduciaries, case law established that they were not general ERISA fiduciaries. Directed trustees were generally permitted to assert reliance upon a fiduciary’s direction as a complete defense to any ERISA claim.⁷⁴ That was the state of the law before *Enron*.

In *Enron*, plaintiffs charged Northern Trust with breach of fiduciary duty because it accepted the direction of the appointed fiduciary to institute a “lockdown period” during which participants would be unable to sell their Enron stock. The directed trustee moved to dismiss the claim, contending that it had no obligation to investigate the propriety of the fiduciary’s instruction under ERISA (the plan permitted such lockdowns) and was absolutely entitled to rely upon it. Plaintiffs acknowledged that Northern Trust was following a fiduciary’s instructions, but argued that it breached its fiduciary duties in implementing the lockdown because the trustee knew or should have known that the instructions violated ERISA. The court denied the motion to dismiss, holding that a trustee still had an obligation to investigate a fiduciary’s instruction to determine its compliance with ERISA.⁷⁵

Since *Enron*, courts have divided over whether directed trustee liability can be adjudicated on a pleading motion. The First Circuit recently affirmed dismissal of Putnam, the directed trustee, albeit on slightly different grounds than the district court. The First Circuit reasoned that Putnam was not a fiduciary because it was not responsible for the ESOP's choice to invest in Textron stock.⁷⁶ Other courts have denied directed trustees' motions to dismiss where plaintiffs have merely alleged that the trustee was aware of some information that made the investment not prudent.⁷⁷

As a result of these decisions, the directed trustee industry requested the DOL to issue some clarification of this constituent's duties. In December 2004, the DOL issued a Field Assistance Bulletin in an attempt to provide some guidance to directed trustees.⁷⁸ While the Bulletin was written in response to a request from the American Bankers Association and provides some direction, it still leaves many questions unanswered. The Bulletin acknowledges that many of these questions are "difficult."⁷⁹ Essentially, the Bulletin states that a trustee may follow proper directions that are consistent with ERISA.

In an uncontroversial assertion, the Bulletin states that a trustee is responsible for reading and knowing the plan's written documents in order to determine the propriety of a fiduciary's direction under the terms of the plan. If the terms of the plan are ambiguous or unclear, the trustee may rely upon a clarification from the responsible fiduciary.⁸⁰ However, the trustee may not follow an instruction that violates ERISA, either because it is a prohibited transaction or not prudent.

With regard to prudence, the Bulletin emphasizes that the trustee is charged with material nonpublic information, or at least such information that is in the hands of, or known to, trustees responsible for implementing the client's instructions.⁸¹ Moreover, such information does not always fit the securities definition of material nonpublic information. For example, the Bulletin instructs that if the trustee "concludes" after performing an internal analysis that a company's financial statements are "materially inaccurate," then it is charged with such knowledge for purposes of performing its ERISA functions.⁸² Generally, a trustee is entitled to rely upon public information under the efficient market theory. However, where the public information discloses extraordinary events or a risk of insolvency, the Bulletin charges a trustee with such information and the trustee must consider that information in exercising its duties.⁸³ Finally, the Bulletin states that a trustee would have to carefully consider its options where fiduciaries instruct the trustee to acquire or to hold securities after state or federal regulators have charged the company, its officers or the directors with "financial irregularities." A trustee may always follow the "proper directions" of an independent fiduciary.⁸⁴

Recently, a district court applied the Field Bulletin in the *WorldCom* action and granted a directed trustee's motion for summary judgment.⁸⁵ In *WorldCom*, participants sued Merrill Lynch, the 401(k) plan's directed trustee, contending that it should have unilaterally frozen plan investment in the company's stock and later liquidated all stock as a plan asset. Merrill Lynch contended that although WorldCom stock had

declined, there were no public indications that such action was warranted.

The district court held that Merrill Lynch did not breach the limited fiduciary duty that it owed to participants. The court emphasized the limited nature of Merrill Lynch's services, observing that the "choice of investment options" remains in the hands of the plan fiduciaries and "a directed trustee has no duty to investigate the wisdom of those choices or any obligation to render advice regarding those choices." Relying upon the Field Bulletin, the court held that a duty of inquiry only arises when a trustee knows or should have known of reliable public information that calls the company's financial viability into question.⁸⁶ In this regard, the court observed that analyst recommendations to investors to sell the company's securities do not constitute reliable information, which would trigger a duty of inquiry. Moreover, mere declines in the company's stock price or financial fortunes also do not raise a duty of inquiry.⁸⁷ Since plaintiffs raised no evidence that Merrill Lynch possessed any public information warranting further inquiry, the court granted the motion for summary judgment.

Motions to Dismiss Claims

In stock drop cases, courts have been reluctant to grant pleading motions dismissing complaints.⁸⁸ While some decisions have granted such relief,⁸⁹ the case law is again inconsistent and not easily reconciled. With these caveats, the major pleading issues are whether fiduciaries have a duty to override plan design, including whether fiduciaries are entitled to a presumption of fiduciary prudence when they follow plan design and whether fiduciaries may raise the securities laws' prohibition against disclosure of material inside information as a defense to a fiduciary disclosure claim.

Plan Design and Fiduciary Prudence

As a general matter, fiduciaries must administer the plans as written and are not permitted to vary from plan design.⁹⁰ Prior to the current wave of stock drop cases, this provision of ERISA was noncontroversial and was believed to constitute a substantial defense against a participant's claim that a fiduciary breached his statutory duties by following a plan.⁹¹

This prestock case law has its genesis in ESOP litigation. In the ESOP area, participants filed several actions in the early 1990s charging fiduciaries with breaching their fiduciary duties by failing to divest company stock from the plans. Since ERISA expressly stated that ESOPs shall invest their assets "primarily" in company stock and excepted ESOPs from the duty to diversify, defendants argued that they could not be charged with a fiduciary breach for failing to diversify.⁹² Defendants persuasively contended that Congress

If public information shows risk of insolvency, trustees must consider it in exercising duties.

was well aware of the risks posed to retirement savings by ESOPs, but nevertheless encouraged their development for policy reasons.⁹³ The problem was posed by two seemingly irreconcilable statutory provisions: section 404, requiring a fiduciary to diversify, and section 407, excepting ESOPs from the duty to diversify. Prior to the current wave of stock drop litigation, however, a federal appellate decision⁹⁴ and a DOL opinion letter⁹⁵ questioned whether ESOP fiduciaries could absolve themselves entirely based upon the nondiversification statutory provision.

To reconcile these provisions, courts developed the doctrine of the presumption of fiduciary prudence. In *Moench v Robertson*,⁹⁶ the Third Circuit illustrated this doctrine. Bank ESOP participants sued after the bank's failure and subsequent seizure by the FDIC. Plaintiffs contended that the plan fiduciaries should have divested the bank shares from the plan. The fiduciaries argued that they were entitled to rely upon the statutory exemption for ESOP plans. The district court granted the fiduciaries' motion for summary judgment, holding that they were entitled to rely upon the statutory provision excepting ESOPs from any diversification requirement.⁹⁷

On appeal, the Third Circuit reversed and remanded. The Third Circuit commented that the statute presented an inherent conflict, which courts needed to address in order to provide "a way for the competing concerns to coexist."⁹⁸ To evaluate an ESOP fiduciaries' decision under a strict fiduciary standard was inappropriate and "would render meaningless the ERISA provision excepting ESOPs from the duty to diversify."⁹⁹ Accordingly, the Third Circuit adopted an abuse of discretion standard to evaluate fiduciaries' compliance with the statute. It held that "keeping in mind the purpose behind ERISA and the nature of ESOPs themselves ... an ESOP fiduciary who invests the assets in company stock is entitled to a presumption that it acted consistently with ERISA by virtue of that decision. However, the plaintiff may overcome that presumption by establishing the fiduciary abused its discretion."¹⁰⁰ The Third Circuit vaguely described the showing necessary to rebut the presumption, simply stating that plaintiffs may introduce evidence that demonstrates continued investment in employer securities would defeat the purpose of the trust because of unanticipated and unknown circumstances at the time the plan was settled. The court also commented that fiduciaries could show that they impartially considered alternative actions to demonstrate that they properly exercised their discretion. The court cautioned that in evaluating this presumption, a district court must keep in mind that if a fiduciary "does not maintain the investment in employer's securities, it may face liability for that caution, particularly if the employer's securities thrive."¹⁰¹

For better or worse, this case law has been interjected into stock drop cases on plan design and prudence. Plaintiffs unsuccessfully have attempted to distinguish this authority on the grounds that ESOPs are statutorily charged with investing in company stock.¹⁰² As is true with much of the stock drop law, the *Enron* decision also created some confusion and ambiguity in these prudence concepts. The *Enron* court adopted the DOL's view, as

expressed in its remarkable amicus brief, which argued that notwithstanding the provisions of a company plan requiring investment in employer securities and ERISA's provisions deleting the diversification requirements for EIAPs, fiduciaries still had an obligation to examine the prudence of the investment.¹⁰³ Although the court adopted the DOL's view that fiduciaries must always exercise prudence and consider diversification, it was unnecessary to make such a broad holding. As the *Enron* court commented, *Enron's* plan contained boilerplate language, which generally required fiduciaries to exercise prudence and to diversify plan investments "unless it is clearly not prudent to do so."¹⁰⁴ Several district courts have adopted the *Enron* court's reasoning and routinely have denied motions to dismiss breach of fiduciary claims alleging failure to diversify or to exercise prudence.¹⁰⁵ The decisions suggest that a fiduciary's obligations increase in the presence of allegations of fraud.

The recent appellate decisions have not resolved the issues, although one decision sharply questions plaintiffs' theory. The First and Ninth Circuits have held that the *Moench* standards apply with full force to stock drop cases involving ESOPs but remain divided over whether such a defense can be asserted on a pleading motion. The difference between the two decisions may rest on the simple distinction that one complaint asserted merely a market drop and the other pleading alleged securities fraud, which required discovery for resolution.

In *Wright v. Oregon Metallurgical Corp.*,¹⁰⁶ the Ninth Circuit questioned the *Moench* standard consistency with ERISA, given the statute's express treatment of the diversification requirement for ESOPs.¹⁰⁷ In *Wright*, plaintiffs sued after the company's stock declined following a merger with a telecommunications firm. There were no allegations of corporate fraud or mismanagement. The Ninth Circuit applied the *Moench* presumption and affirmed a district court's dismissal of a stock drop lawsuit against ESOP fiduciaries. The district court found that the fiduciaries had no obligation to investigate diversification merely because the stock fluctuated after the merger.¹⁰⁸

In contrast, the First Circuit adopted the *Moench* test in an ESOP case, but reversed the district court's dismissal of fiduciaries. In *Lalonde v. Textron, Inc.*,¹⁰⁹ plaintiffs sued fiduciaries, the issuer, and the directed trustee alleging that defendants violated their fiduciary duties by failing to diversify the ESOP's assets. Plaintiffs alleged that Textron and its fiduciaries, some of whom were senior corporate officers, participated in a scheme, or at least had knowledge of the violations, to inflate Textron's stock value. The ESOP sustained a financial loss, at least on paper, because the value of Textron's shares declined. The First Circuit held that as a matter of pleading, it was impossible to determine that plaintiff could prove any set of facts to support their claims. The court noted that if plaintiffs proved their claims that the fiduciaries participated, in essence, in securities fraud, then defendants might have breached their fiduciary duties owed to participants. The First Circuit reasoned, "the odds of plaintiffs' succeeding on their

breach of fiduciary duty claims against the Textron defendants might be very long, but ‘that is not the test [on a motion to dismiss].’”¹¹⁰

Pleading Motions and Securities Law Defenses

With a few exceptions, courts have not granted defense motions based upon securities law arguments, including the assertion that the insider information provisions of the statutes prohibit fiduciaries’ selective disclosure of corporate information to participants.¹¹¹ As with much of this case law, courts have not fully developed their reasoning in adjudicating these defenses. These arguments may yet present some of the best defense arguments, especially where defendants have not engaged in fraud or self-dealing.

First, defendants have argued in several cases that securities statutes, including section 10(b) of the Exchange Act’s prohibition against selective disclosure of material inside information, should govern their disclosure obligations to participants. Two early courts have adopted this argument without engaging in much analysis. In *Hull v. Policy Management Systems Corp.*,¹¹² the district court granted a motion to dismiss the complaint, finding that plaintiff’s claims failed to name for the most part fiduciaries and that with respect to the appropriately named fiduciaries, plaintiffs failed to allege any breach of fiduciary duty. The complaint, which pleaded an ERISA breach of fiduciary duty claim, alleged that the plan committee defendants, who were not alleged to have known of or participated in the securities fraud, should have determined the adequacy of the company’s disclosure. There were no allegations that the fiduciaries had sold stock based on inside information or had engaged in any company stock transactions. The district court reasoned that these allegations failed to state a claim because the securities laws prohibited the committee from trading securities based upon material inside information.¹¹³

Without much analysis, a California district court in 2002 dismissed a similar claim, simply observing that “[f]iduciaries are not obligated to violate the securities laws in order to satisfy their fiduciary duties.”¹¹⁴ In its *Enron* amicus brief, the DOL announced that it rejected this case law.¹¹⁵ It is an open question whether this case law is isolated or will be followed by other courts.

Subsequent courts have refused to follow this authority, holding that fiduciaries’ obligations under ERISA transcend any securities concerns. In *Enron*, the DOL argued that fiduciaries could follow several courses of action, including disclosing material adverse information to all shareholders or eliminated company stock as a permitted investment and match. The DOL asserted that the securities laws always permit insiders to either “disclose or abstain” from trading when they become aware of material inside information.¹¹⁶ The *Enron* court and several other courts have adopted this position, rejecting the insider-trading defense.¹¹⁷

These cases are not inconsistent, especially at a pleading stage. They often involve allegations, perhaps deliberately pleaded by plaintiffs to overcome this defense, that fiduciaries traded for their own account based upon inside information. The “disclose or abstain” principle flows from trust law and is

well recognized in securities law.¹¹⁸

Preemption of State-Based Claims

Plaintiffs sometimes allege state-based tort claims or common law causes of action.¹¹⁹ ERISA contains a comprehensive preemption provision,¹²⁰ which expressly preempts any state law that relates to a pension plan. Such claims are almost invariably preempted.

The Supreme Court has held that a state law claim will relate to an employee benefits plan if it has connection with or reference to such a plan.¹²¹ Therefore, any common law claims that either rely on the existence of an ERISA plan to state a claim, or attempt to provide a remedy for misconduct growing out of the administration of an ERISA plan, are sufficiently connected with a plan to be preempted by ERISA.¹²²

Punitive Damages

Plaintiffs sometimes plead claims for punitive damages. While ERISA permits federal courts some discretion in fashioning relief, the Supreme Court has held that punitive damages are generally not available in breach of fiduciary duty cases.¹²³ In addition, a state-based claim asserting punitive damages, which relies upon the plan, should be preempted.¹²⁴

Cofiduciary and Respondent Superior Claims

There is a growing trend for plaintiffs to assert claims against ancillary parties, such as directed trustees or directors. Plaintiffs often assert claims that the plan sponsor is liable on a respondent superior theory, claiming that it controlled the actions of fiduciaries who committed the misdeeds.¹²⁵ In addition, plaintiffs assert cofiduciary claims under ERISA § 405¹²⁶ against directed trustees, directors, or other corporate officers.¹²⁷ Courts traditionally have been wary of applying respondent superior in fiduciary cases, requiring the principal to have knowledge of the agents’ wrongdoing.¹²⁸ The stock drop pleading decisions have blurred that line. While some courts have rejected such claims as a matter of pleading,¹²⁹ several courts have held that these allegations state claims.¹³⁰

Plaintiffs have also pleaded such claims under ERISA § 405,¹³¹ which recognizes cofiduciary liability. Section 405(a) makes each fiduciary “liable for a breach of fiduciary responsibility of another fiduciary with respect to the same plan if he participates knowingly in, or knowingly undertakes to conceal, an act or omission of such other fiduciary, knowing such act or omission is a breach.”¹³²

To have cofiduciary liability, courts have held that each defendant, in accordance with the express terms of the statutes, must be a fiduciary.¹³³ Some courts, however, have

Some courts now mix the concepts of respondent superior and cofiduciary liability to approve pleadings against nonfiduciaries.

begun to mix the two concepts of respondent superior and cofiduciary liability to approve pleadings of cofiduciary liability against a nonfiduciary on the grounds that it controlled a fiduciary who participated in a breach.¹³⁴ Another court has suggested that a defendant who is a fiduciary may be held liable under section 405(a) for concealing a fiduciary-breach to the extent he does not disclose what he learned before he became a fiduciary.¹³⁵

404(c)

Section 404(c) of ERISA¹³⁶ relieves EIAP fiduciaries of fiduciary responsibility for any losses that are incurred by plan participants as a result of their investment directions. In accordance with the statute, DOL has promulgated regulations implementing this provision. Under the DOL regulations, a plan must meet two elements to qualify for 404(c) treatment: (i) diversified investment options; and (ii) opportunity for participants to exercise control over their assets, which includes having sufficient information for participants to make sound investment decisions.¹³⁷ The regulation states that sufficient information means providing participants with the 33 Act filings for a publicly held security.¹³⁸ The DOL has asserted that section 404(c) does not apply to the fiduciary's selection of investment alternatives.¹³⁹

Even though the DOL has asserted that section 404(c) does not apply to the selection of investment alternatives, even where there are numerous alternatives, both the legislative history and at least one court suggest otherwise. In discussing the intent underlying section 404(c), the House Committee Report unequivocally stated: "If the participant instructs the plan trustee to invest the full balance of his account in, e.g., a single stock, the trustee is not liable for any loss because of a failure to diversify or because the investment does not meet prudent-man standards."¹⁴⁰ In a non-stock drop case, the Third Circuit in the case of *In re Unisys Plan Litigation*,¹⁴¹ suggested that section 404(c) is comprehensive, holding that a fiduciary, who committed a breach, could not be held liable for a participant's exercise of control over her investments. The Third Circuit, however, reversed a summary judgment on whether the plan qualified as a 404(c) plan.¹⁴²

Although many sponsors have qualified their plans under section 404(c), the statute has not deterred stock drop claims. Many complaints acknowledge that the plans are 404(c) plans, but affirmatively allege that the plans do not qualify under the regulations. Courts have been hostile to pleading motions seeking to dismiss claims on the ground that the plan is a section 404(c) plan.¹⁴³ Courts have held that the fiduciary has the burden of demonstrating that the statute applies.¹⁴⁴ Plaintiffs' contentions that the plan lacks 404(c) protection usually center on

the lack of diversified investment alternatives or the adequacy of information regarding the stock.¹⁴⁵ Courts have found such reasons sufficient to preclude a Rule 12 dismissal. *

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1. See, e.g., *Experts Warn of Emerging Trend in ERISA Class-Action Lawsuits at PLUS Symposium*, available at www.insurancejournal.com/news/national/2004/06/28/43635.htm; *Lawyering Up* (October 2004) available at www.plansponsors.com/magazine_topic/.
2. See, e.g., Employee Benefit Research Institute, Jack Van Derhei, *Retirement Security and Defined Contribution Plans: The Role of Company Stock in 401(k) Plans*, written statement for the Senate Finance Committee, HEARING ON RETIREMENT SECURITY: PICKING UP THE ENRON PIECES, Feb. 27, 2002, available at www.ebri.org/testimony/t135.pdf.
3. *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090 (9th Cir. 2004); *Lalonde v. Textron, Inc.*, 369 F.3d 1 (1st Cir. 2004).
4. *Landruff v. Columbia/HCA*, No. 3-98-0090 (M.D., Tenn. May 24, 2000), *aff'd*, 2002 WL 203208 (6th Cir. 2002).
5. See, e.g., Brett Nelson, *Open Season on 401(k)s; Lawyers Line Up to Sue Employers with Thrift Plans*, FORBES, Nov. 25, 2002 at 60.
6. Virtually all of these actions make this allegation. See e.g., *In re Enron Corp. Securities, Derivative and ERISA Litigation*, No. Civ. A. H-01-3913 (S.D. Tex. filed Nov. 13, 2001); *In re WorldCom, Inc. Securities ERISA Litigation*, No. 1:02-MDL-01487-DLC (S.D.N.Y. filed Oct. 16, 2002); *In re Global Crossing ERISA Litigation*, Case No. 1:02-CV-07453-GEL (S.D.N.Y. filed Sept. 16, 2002).
7. This is also one of the most common claims. See, e.g., Schilling v. CMS Energy Corp., Case No. 02-72834 (E.D. Mich. filed July 11, 2002) ("Defendants CMS Energy ... as the named fiduciaries of the Consumer Energy Plan filed to discharge their duties ... by among other things ... causing the Consumer Energy Plan to continue to offer the Company Stock Funds as investment options for the investment of new assets of the Plan at a time when Defendants knew or should have known that new shares of Company Stock were inflated in price and were not a prudent investment for the Plan.") (Complaint ¶ 56(d)).
8. This claim is sometimes made with tech stocks. See, e.g., Hill McCourt, No. 03:04 C.S.V. 5368 (D.N.J. filed Nov. 5, 2004) (Complaint ¶ 25).
9. See, e.g., *Muller v. Merck & Co., Inc.*, No. 04-2716 (E.D. La., filed Sept. 30, 2004). (Pursuant to ERISA section 404, defendants had a duty to discharge their duties with respect to the Plans solely in the interests of Participants and for the exclusive purpose of providing benefits to Participants. As alleged above, defendants engaged in a scheme and course of conduct to artificially inflate the price of Merck stock, thereby allowing them to benefit from the artificial inflation in the form of stock options, stock ownership and in other ways connected to executive compensation at Merck. Defendants breached their fiduciary obligations when they acted in their own interests rather than solely in the interests of the participants.)
10. *Wolf v. Aquila Inc.*, No. 4:04 CV 934 (W.D. Mo. filed Oct. 12, 2004) (¶¶ 47-52).
11. These claims are almost always made. See, e.g., *In re Sprint Corporation ERISA Litig.*, (D. Kan. filed Oct. 9, 2004), Third

Courts have held that the fiduciary carries the burden to prove section 404(c) applicability.

Amended Complaint ¶¶ 112-113 (citing misstatements in 34 Act filings).

12. Fagan v. Aon Corp., Case No. 04:7650 (N.D. Ill., filed Nov. 26, 2004); Spear v. Hartford Financial Services Group Inc., No. 04-1790 (D. Conn., filed Oct. 22, 2004).

13. *In re Global Crossing, ERISA Litig.*, No. 2:02 CV 1478 (S.D.N.Y., filed Feb. 12, 2002).

14. Tatum v. RDR Pensions Investment Committee, No. 1:02CV373 (M.D.N.C. filed May 13, 2002); Bunch v. W.R. Grace & Co., Inc., No. 64-218-DLB (E.D. Ky., filed Oct. 26, 2004).

15. ERISA recognizes two general categories of retirement plans, which are defined benefit plans and defined contribution plans. See generally *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 433 (1999). A defined benefit plan is the traditional retirement pension where the participant is entitled to a fixed payment upon retirement. *Id.* at 439. Defined contribution plans, on the other hand, establish an individual account for each participant, to which the employee makes contributions, often augmented by the employer. In a defined contribution plan, the participant makes the investment decision and assumes the risk of loss.

16. ERISA 407(d)(3), 29 U.S.C. § 1107(d)(3).

17. This result reflects the interplay between ERISA §§ 404 and 407, 29 U.S.C. § 1104, § 1107. Company stock in a plan, other than an EIAP, is subject to diversification requirements that prohibit a large concentration in a single security or other asset. ERISA § 407(a), 29 U.S.C. § 1107(a)(2). Such a plan may not invest more than 10% of its total plan assets in a single security or other asset. In sharp contrast, an EIAP is not subject to this rule, or any limitation and may be 100% invested in company stock, subject to certain other limitations. ERISA § 407(b)(1), 29 U.S.C. § 1107(b)(1). Congress intended this result so long as the plan discloses this intent. The House/Senate Conference Committee on ERISA states: “[A] special rule is provided for individual account plans ... since these plans commonly provide for substantial investments in [company stock] ... In recognition of [their] *special purpose* ... the 10 percent limitation with respect to the acquisition or holding of [company stock] ... does not apply to such plans if they explicitly provide for greater [than 10 percent] investment in [company stock]. In addition, the diversification requirements of [ERISA are] not to restrict investments by [EIAPs] in [company stock].” Joint Explanatory Statement of the Committee of Conference on H.R. 2; H.R. Rep. No. 93-1280 (Conference Report) at 317 reprinted in 1974 U.S.C.C.A.N. 5038, 5097 (emphasis added). As the Committee Report explained, “In this way, the persons responsible for asset management, as well as the [plan participants] will clearly know the extent [sic] to which the plan can acquire and hold [company stock.]” *Id.*

18. Congress has provided many incentives in the tax code. There are lowered taxes on plan distribution made in kind on employer stock. IRC § 402(e)(4)(B), 26 U.S.C. § 402(e)(4)(B). Participants are able to receive full distribution without having to sell any securities to satisfy a withholding requirement. IRC § 3405(e)(8), 26 U.S.C. § 3405(e)(8). Plan sponsors can contribute stock-in-kind without violating ERISA’s prohibited transaction rules. IRC § 4975(d)(13), ERISA § 408(e). Dividends paid on company stock contributed for the plan can be tax deductible. IRC § 404(i), 26 U.S.C. § 404(k). Finally, plans are provided a special exemption from the prohibited transaction rules in order to present the plan to borrow

from the employer in order to finance the acquisition of company stock. Treas. Reg. § 54.4975, 26 C.F.R. § 54.4975.

19. ERISA § 3(16)(B), 29 U.S.C. § 1002(16)(B). Under ERISA, sponsoring a plan is not considered a fiduciary function. Rather such activities are regarded as “settlor” in nature. *Lockheed Corp. v. Spink*, 517 U.S. 882, 889-90 (1996) (“[p]lan sponsors who alter the terms of a plan do not fall into the category of fiduciaries ... When employers undertake these actions, they do not act as fiduciaries. ... but are analogous to the settlors of a trust.”); *Hughes Aircraft Co. v. Jacobson*, 525 U.S. at 433 (“an employer’s decision to amend a pension plan concerns the composition or design of the plan itself and does not implicate the employer’s fiduciary duties which consist of such actions as the administration of the plan’s assets.”). See also *In re Louisiana-Pacific Corp. ERISA Litig.*, 2003 WL 21087593 (D. Or. Apr. 24, 2003) (granting motion to dismiss Louisiana-Pacific, the sponsor, in a stock drop case on grounds that it was not a fiduciary).

20. ERISA § 402(a)(1), 29 U.S.C. § 1102(a)(1).

21. ERISA § 404(a)(1)(B); 29 U.S.C. § 1104(a)(1)(B).

22. ERISA § 404(a)(1)(D), 29 U.S.C. § 1104(a)(1)(D)

23. ERISA § 402(a)(1), 29 U.S.C. § 1104(a)(1).

24. See, e.g., BETTY L. KRIKORIAN, FIDUCIARY STANDARDS IN PENSION AND TRUST FUND MANAGEMENT, § 2.05 at 2-19-20 (1995).

25. ERISA § 3(21)(A), 29 U.S.C. § 1002(21)(A).

26. ERISA prescribes a functional test for fiduciary status. Section 3(21)(A) of ERISA, 29 U.S.C. § 1002(21)(A), provides that: A person is a fiduciary with respect to a plan to the extent (i) he exercised any discretionary authority or discretionary control respecting management of such plan or exercised any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any monies or other property of such plan or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of a plan.

This definition is “functional,” i.e., one is a fiduciary only if—and only to the extent—he is performing a function described in Section 3(21)(A). See *Banistor v. Unman*, 287 F.3d 394, 401 (10th Cir. 2002), quoting *Sommers Drug Stores Co. Employee Profit Sharing Trust v. Corrigan Enters., Inc.*, 793 F.2d 1456, 1459-60 (5th Cir. 1986), cert. denied, 479 U.S. 1034 (1987); *Johnson v. Georgia-Pacific Corp.*, 19 F.3d 1184, 1188 (7th Cir. 1994) (citation omitted); *Coleman v. Nationwide Life Ins. Co.* 969 F.2d 54, 61 (4th Cir. 1992), cert. denied, 506 U.S. 1081 (1993) (citations omitted); *Martin*, 965 F.2d at 669 (citations omitted); *Aull v. Cavalcade Pension Plan*, 185 F.R.D. 618, 623 (D. Colo. 1998); *Alkire v. Flssel*, 1994 U.S. Dist. Lexis 18722, at *11 (D. Kan. Dec. 12, 1994), 13 quoting *Payonk v. HMW Indus., Inc.* 883, F.2d 221, 225 (3d Cir. 1989).

27. See, e.g., *Firstiers Bank N.A. v. Zeller*, 16 F.3d 907, 911 (8th Cir.), cert. denied, 513 U.S. 871 (1994); *IT Corp. v. General Am. Life Ins. Co.*, 107 F.3d 1415, 1421 (9th Cir. 1997).

28. 29 C.F.R. § 2509, 75-8, Q&A D-4 (2004).

29. *Pegram v. Herdrich*, 530 U.S. 211, 226 (2000); *Flake v. Hoskins*, 55 F. Supp. 2d 1196, 1218 (D. Kan. 1999) (“[f]iduciary duty is not an all-or-nothing concept; defendants have fiduciary duties only over those activities for which they are responsible.”).

30. *Pegram*, 530 U.S. at 226 (“[i]n every case charging breach of

ERISA fiduciary duty, then, the threshold question is not whether the actions of some person employed to provide services under a plan affected a plan beneficiary's interest, but whether that person was acting as a fiduciary (that is, was performing a fiduciary function) when taking the action subject to complaint."); *In re Williams Cos. ERISA Litig.*, 271 F. Supp. 2d 1328, 1339 (N.D. Okla. 2003) (granting director defendants' motion to dismiss complaint on grounds they were not general ERISA fiduciaries and complaint demonstrates no nexus between alleged breach and plaintiff's harm); *In re Worldcom Ins. ERISA Litig.*, 263 F. Supp. 2d 745, 760-1 (S.D.N.Y. 2003) (*supra*); *Crowley v. Corning Inc.*, 234 F. Supp. 2d 222, 228-30 (N.D.N.Y. 2002); *In re Reliant Energy ERISA Litig.*, No. H-02-2051 (S.D. Tex., Jan. 30, 2004) at 15-6 (dismissing claims against Reliant on grounds that it was not a general ERISA funding and plaintiffs failed to plead causation.).

31. ERISA § 404, 29 U.S.C.S. 1104; *Donovan v. Bierwirth*, 680 F.2d 263, 272, n.8 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982).

32. *Pegram*, 530 U.S. at 225.

33. *Bussiam v. RJR Nabisco, Inc.*, 223 F.3d 286, 294 (5th Cir. 2000); *Martinez v. Schlumberger, Ltd.*, 383 F.2d 407, 412-13 (5th Cir. 2003).

34. *Pegram*, 530 U.S. at 225.

35. The *Enron* decision probably best exemplifies the doctrine where the court adopted an expansive definition of fiduciary responsibility to reach even the directors and directed trustees. *In re Enron Corp. Securities, Derivative and ERISA Litig.*, 284 F. Supp. 2d 511, 581-602 (S.D. Tx 2003).

36. *See, e.g., In re Sprint Corporation ERISA Litig.*, No. 2:03-2202-JWL (D. Kan. Filed Oct. 9, 2003).

37. Plaintiff alleged, for example, in *Sprint* that defendants should have realized the traditional telephone business was subject to a decline. (Third Amended Complaint filed Oct. 9, 2004, ¶¶ 93 -94).

38. *In re Xcel Energy, Inc. Securities Derivative & ERISA Litig.*, 312 F. Supp. 1165, 1174 (D. Minn. 2004); *In re Sprint Corporation ERISA Litig.*, 2004 WL 1179371 (D. Kan. 2004) ("the court rejects the Sprint defendants' impending collapse theory, i.e., that a plan must plead the impending collapse of a company in order to over-

come the ESOP presumption") at 11.

39. *Wright v. Oregon Metallurgical, Inc.*, *supra*.

40. *See, e.g., Crowley v. Corning, Inc.*, No. 02 CV 6172 (filed April 1, 2002, N.D.N.Y.).

41. 29 U.S.C. § 1102(a)(1).

42. 29 U.S.C. § 1102(a)(2).

43. 29 U.S.C. § 1102(a)(3).

44. *Mertens v. Hewitt Associates*, 516 U.S. 489 (1996); *Great-West Life & Annuity Co. v. Knudson*, 534 U.S. 204 (2002); *Millsap v. McDonnell Douglas Corp.*, 368 F.3d 1246, 1260-61 (10th Cir. 2004).

45. *See, e.g., Howell v. Motorola, Inc.*, 2004 WL 2125373 (N.D. Ill. Sept. 23, 2004) at 7 (distinguishing stock drop case that predicates liability on breach of fiduciary duty or negligent misrepresentations from fraud claim); *In re AEP ERISA Litig.*, 327 F. Supp. 2d 812, 822 (S.D. Ohio 2004) ("[T]his Court can discern no reason why, generally, ERISA plaintiffs should have to meet heightened pleading requirements, as opposed to the 'simplified notice pleading standard [that] relies on liberal discovery rules and summary judgment motions to define disputed facts and issues and to dispose of unmeritorious claims'"); *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 284 F. Supp. 2d 511, 652 (S.D. Tex. 2003)

("ERISA does not even have heightened pleading requirements, but is subject to the notice pleading standard. ...") (citation omitted);

In re Worldcom, Inc., 263 F. Supp. 2d 745, 759 (S.D.N.Y. 2003)

(Rule 8 satisfied even though allegations regarding defendant's fiduciary status did little more than restate statutory definition);

Ranklin v. Rots, 278 F. Supp. 2d 853, 866 (E.D. Mich. 2003)

("While some of the allegations in support of [plaintiffs'] claim are similar to fraud allegations, i.e., that [defendants] provided false and misleading information, the gravamen of [plaintiffs'] claims is grounded in ERISA. The heightened pleading requirement under Rule 9(b) will not be imposed where the claim is for a breach of fiduciary duty under ERISA.")

Nelson v. Ipalco Industries, Inc., 2003 WL 402253 at *3 (S.D. Ind. 2003) (same).

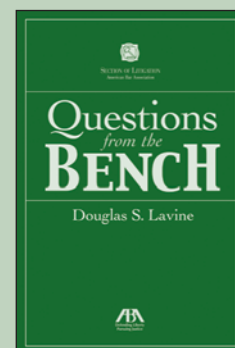
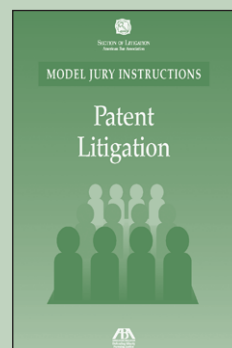
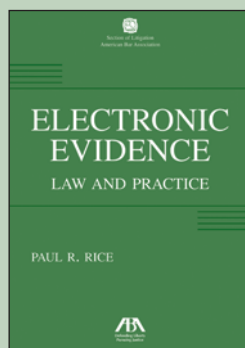
In re Dynegey Inc. ERISA Litig., 2004 WL 540529 *4 (S.D. Tex. Mar. 5, 2004) (same).

But see In re Sears Roebuck & Co. ERISA Litig., 2004 WL 407007

(N.D. Ill. 2004) ("9(b) applies to ERISA claims that allege misrep-

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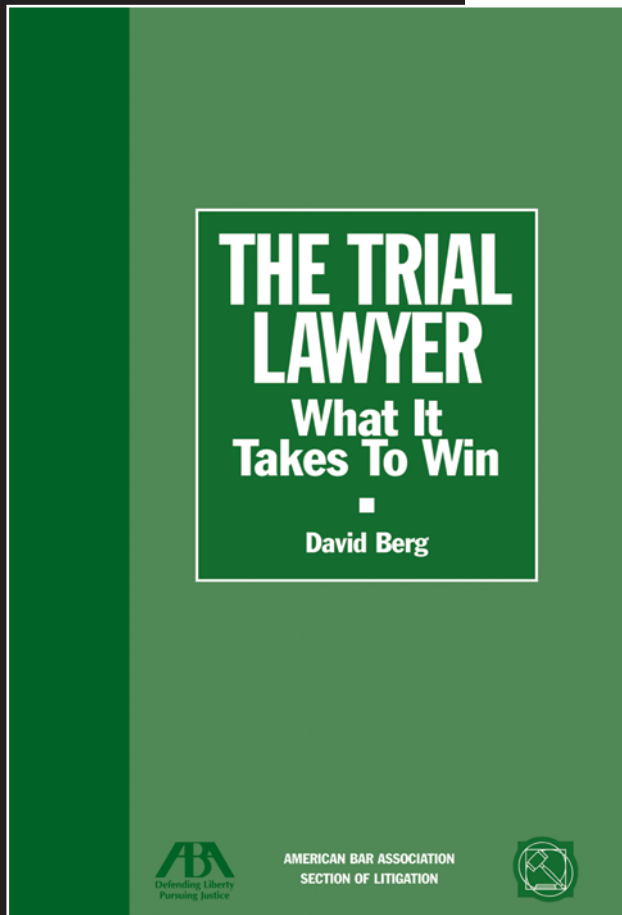
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- resentations”); *In re Ikon Office Solutions Inc. Securities Litig.*, 86 F. Supp. 2d 481, 488 (E.D. Pa. 2000) (same); *Cokenour v. Household Int’l Inc.*, 2004 WL 725973 at 8 (N.D. Ill. 2004) (Rule 9(b) applies to intentional misrepresentation claims).
46. *In re Ikon Office Solutions, Inc. Securities Litig.*, 86 F. Supp. 2d 481, 488 (E.D. Pa. 2000) (where complaint alleges that ERISA defendants “participated in fraudulent practices,” Rule 9(b) applies).
47. *In re Enron Corp.*, 284 F. Supp. 2d at 577-79.
48. *In re Enron Corp.*, 284 F. Supp. 2d at 577-79; *In re Electronics Data Systems, Corp. ERISA Litig.*, 305 F. Supp. 2d 658, 673 (E.E. Tex. 2004).
49. *See e.g., In re Electronic Data Systems ERISA Litig.*, 305 F. Supp. 2d 658, 666-67 (N.D. Tex. 2004) (accepting plaintiffs’ boilerplate allegations against board members, holding such allegations apparent to deny pleading motion); *Howell v. Motorola Inc.*, 2004 WL 2125373 (N.D. Ill. Sept. 23, 2004).
50. 29 U.S.C. § 1102(21)(A).
51. *Reich v. Lancaster*, 55 F.3d 1034, 1044 (5th Cir. 1995); *In re Electronic Data Systems Corp. ERISA Litig.*, 305 F. Supp. at 664.
52. *See, e.g., Akers v. Palmer*, 71 F.3d 226, 230 (6th Cir. 1995) (“[a] party does not become a fiduciary simply by a litigant’s assertion that this is the case.”); *Carpenters Health & Welfare Trust Fund v. Tri-Capital Corp.*, 25 F.3d 849, 856 (9th Cir. 1994) (affirming dismissal of defendant on pleading grounds where comfort “no indication” of what facts supported fiduciary status).
53. *Crowley v. Corning, Inc.*, 234 F. Supp. 222, 228 (W.D.N.Y. 2002) (ERISA fiduciary claims against plan sponsor dismissed on Rule 12(b)(6) motion because complaint “contains no factual allegations which support a claim that [plan sponsor] had *de facto* control over the Committee members”).
54. *See, e.g., In re Providian Financial Corp. ERISA Litig.*, No. C01-05027 (N.D. Cal. Nov. 14, 2002) (dismissing complaint because “plaintiffs have lumped the various classes of defendants into an undifferentiated mass and allege that all of them violated all of the asserted fiduciary duties”).
55. *In re Louisiana Pacific ERISA Litig.*, *supra* at 5; *Tatum v. R.J. Reynolds Tobacco Co.*, 294 F. Supp. 2d 776, 783 (M.D. N.C. 2003).
56. 453 U.S. 322 (1981).
57. 453 U.S. at 336-38.
58. *Lockheed Corp. v. Spink*, 517 U.S. 882, 889-90 (1996).
59. *Kling v. Fidelity Management Trust Co.*, 323 F. Supp. 2d 132, 146-47 (D. Mass. 2004) (holding that respondent superior applies); *In re Dynegy Inc. ERISA Litig.*, 309 F. Supp. 2d 861, 904-06 (S.D. Tex. 2004) (holding that *Dynegy* could have cofiduciary status because a corporation can only act through its agents and general *Dynegy* employees acted as plan fiduciaries); *Howell v. Motorola, Inc.*, 337 F. Supp. 2d 1079, 1093-95 (N.D. Ill. 2004) (denying motion to dismiss sponsor, holding that respondent superior may apply).
60. *In re WorldCom, Inc. ERISA Litig.*, 263 F. Supp. 2d at 760-61; *Crowley v. Corning, Inc.*, 234 F. Supp. 2d at 228-30; *In re Williams Cos. ERISA Litig.*, 271 F. Supp. 2d at 1339.
61. *See, e.g., 29 C.F.R. 5 2509, 75:8* (“the personal liability of a fiduciary is not a named fiduciary is generally limited to the fiduciary functions, which he or she performs with respect to the plan.”); *Brandt v. Grounds*, 687 F.2d 895, 898 (7th Cir. 1982).
62. 530 U.S. 211 (2000).
63. 530 U.S. at 225.
64. *See, e.g., Crowley v. Corning, Inc.*, 234 F. Supp. 2d at 228 (dis-
- missing claim against sponsor because they were not made in a fiduciary capacity).
65. *Crowley v. Corning, Inc.*, 234 F. Supp. 2d at 228.
66. *Howell v. Motorola*, *supra* at 16; *In re AEP ERISA Litig.*, *supra*, 327 F. Supp. 2d at 822; *In re Sprint ERISA Litig.*, 2004 WL 21797371 at 20.
67. *See 29 C.F.R. § 2509.75-8, Q&A D-4 and D5* (officer and director status does not establish fiduciary status; officer-director must undertake a discretionary act described in the statute on behalf of an ERISA plan to be considered a fiduciary); *Cement & Concrete Workers Dist. Council Welfare Funds v. Lollo*, 33 F.2d 29, 33 (2d Cir. 1994) (“individual cannot be held liable for corporate ERISA obligation solely by virtue of his role as an officer, shareholder or manager”); *Sasso v. Cervoni*, 985 F.2d 49, 50-51 (2d Cir. 1993) (an officer “is not liable for corporate ERISA obligations solely by virtue of his role as an officer, shareholder or manager,” even if the individual played a “dominant role in the affairs of a corporate employer”); *Sommers Drug Stores Co. Employee Profit Trust Co. v. Corrigan Enter., Inc.*, 793 F.2d 1456, 1460 (5th Cir. 1986) (reversing judgment entered against corporate officer for breach of ERISA fiduciary duty because jury instructions permitted jury to assume fiduciary status by reason of defendant’s position as a corporate officer); *Arevalo v. Herman*, 2002 U.S. Dist. LEXIS 7076 at *4 (E.D. Va. 2002) (“A business entity’s officer or director who has responsibility for corporate affairs does not have fiduciary responsibility with regard to an employee benefit plan simply by virtue of that corporate position”); *Riley v. Murdock*, 828 F. Supp. 1215, 1219 (E.D.N.C. 1993) (mere allegations that defendant was a majority shareholder are insufficient to establish ERISA fiduciary status; “absent allegations that a party exercised controlling authority over a retirement plan, a mere conclusion in the complaint that a party is a ‘fiduciary’ for ERISA purposes is insufficient”), *aff’d mem.*, 83 F.3d 415 (4th Cir.), *cert. denied*, 519 U.S. 964 (1996).
68. *See, e.g., In re Enron*, 284 F. Supp. 2d at 567-574; *In re WorldCom*, 263 F. Supp. 2d at 759.
69. *See DOL Amicus Brief at 5-8* submitted in *Title v. Enron Corp.*, Civil Action No. H-01-3913 (S.D. Tex., filed Nov. 13, 2001) (DOL *Enron Amicus Brief*).
70. 284 F. Supp. 2d at 657-58.
71. 262 F. Supp. 2d at 759.
72. *Id.*
73. ERISA § 403(a)(1); 29 U.S.C. § 403(a)(1).
74. *See, e.g., Moench*, 62 F.3d at 571 (a directed trustee is “essentially immune from judicial inquiry”); *Wells Fargo Bank v. Bourns, Inc.*, 860 F. Supp. 709, 716 (N.D. Cal. 1994); *see generally Patricia W. Hatamyar, See No Evil: The Role of the Directed Trustee Under ERISA*, 64 TENN. L. REV. 1, 5405 (1996).
75. *Enron*, 284 F. Supp. 2d at 600-02.
76. *Lalonde*, 369 F.3d at 5.
77. *In re Sprint Corporation ERISA Litig.*, 2004 WL 1179371 (D. Kan. 2004).
78. DOL Field Assistance Bulletin 2004-03, dated Dec. 17, 2004.
79. *Id.* at 1.
80. *Id.* at 2.
81. *Id.* at 3.
82. *Id.* at 4.
83. *Id.* at 4-5.
84. *Id.* at 5.

85. *In re WorldCom, Inc. ERISA Litig.*, 2005 WL 221263 (S.D.N.Y. Feb. 1, 2005).
86. *Id.* at *23.
87. *Id.* at *24.
88. *In re Electronic Data Systems Corp. ERISA Litig.*, 305 F.Supp. 658 (E.D. Tex. 2004); *In re Xcel Energy, Inc. Securities, Derivative and ERISA Litig.*, 715 F.Supp. 2d 1165 (D. Minn. 2004).
89. *Hull v. Policy Management Systems Corp.*, 2001 WL 1836286 (D.S.C. 2001); *Crowley v. Corning*, 234 F. Supp. 2d at 231.
90. ERISA § 404(a)(1)(b); 29 U.S.C. § 1104(a)(1)(B).
91. *Cf.*, *MacDonald v. Pan American World Airways*, 859 F.2d 742, 745 (9th Cir. 1988) (Administrative Committee's interpretation of plan required distribution date was reasonable and did not breach any fiduciary duties by following plan documents).
92. Section 404(a)(2) excepts EIAPs, including ESOPs, from the obligation to diversify company stock. 29 U.S.C. § 1104(a)(2). ESOPs are designed to invest "primarily in qualifying employer securities." ERISA section 407(d)(6)(A), 29 U.S.C. § 407(d)(6)(B).
93. *See, e.g. Martin v. Feilen*, 965 F.2d 660, 664 (8th Cir. 1992) (noting "Congress expressly intended that the ESOP would be both an employee retirement benefit plan and a 'technique of corporate finances' that would encourage employer ownership").
94. *Kuper v. Iovenko*, 66 F.3d 1447, 1457 (6th Cir. 1995).
95. DOL Opinion No. 90-05A.
96. 62 F.3d 553 (3d Cir. 1995).
97. 62 F.3d at 560.
98. *Id.* at 570.
99. *Id.* at 571.
100. *Id.* at 571-2.
101. *Id.*
102. Courts have not distinguished these ESOP cases on this basis. *See In re Tyco International*, slip opinion at 29, n.9.
103. 284 F. Supp. 2d at 668-70.
104. 284 F. Supp. 2d at 668.
105. 360 F.2d 1090 (9th Cir. 2004).
106. *Wright*, 360 F.2d at 1097-98.
107. *Cokenour v. Household International, Inc.*, 2004 WL 725973 (N.D. Ill. 2004) at 4 ("A fiduciary is required to discharge his or her duties with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims. ... Then, the Committee Defendants cannot hide behind the provisions of the Plan") (citation omitted); *In re Sears Roebuck & Co. ERISA Litig.*, 2004 WL 407007 (N.D. Ill. 2004) at 3-4.
108. *Id.*
109. 369 F.3d 1 (1st Cir. 2004).
110. 369 F.3d at 7.
111. Compare *In re McKesson HBOC Inc. ERISA Lit.*, 2002 WL 31431588 at 10 (N.D. Cal. Sept. 30, 2002) (accepting the insider trading defense) with *Enron*, 284 F. Supp. 2d at 565 (rejecting defense and criticizing *McKesson*).
112. *Hull v. Policy Management Systems, Inc.*, 2001 WL 1836286 (D.S.C. 2001).
113. *Id.* at 7-8.
114. *In re McKesson HBOC, Inc. ERISA Litig.*, 2002 WL 31431588 at 10 (N.D. Cal. 2002).
115. *Enron Amicus Brief* at 28 ("to the extent that the [Hull] Court suggested that fiduciaries of employee benefit plans holding employer stock might be in violation of securities laws if they refrained from additional purchases, the decision is simply wrong."): 116. 284 F. Supp. 2d at 555-6.
117. *In re Sears, Roebuck & Co. ERISA Litig.*, 2004 WL 407007 (N.D. Ill. 2004) at 4. *In re Electronic Data Systems Corp. ERISA Litig.*, *supra* at 13.
118. *Chiarella v. United States*, 445 U.S. 222, 238-39 (1980).
119. Such claims may include state-based claims of breach of fiduciary duty, fraud or negligent misrepresentation.
120. *See* ERISA § 514, 29 U.S.C. § 1144.
121. *Ingersoll-Rand Co. v. McLendon*, 498 U.S. 133, 138-39 (1990).
122. *Massachusetts Mut. Life Ins. Co. v. Russell*, 498 U.S. 133, 138-39 (1990).
123. *See, e.g., Ingersoll-Rand*, 498 U.S. at 138-39; *Woodworker's Supply, Inc. v. Principal Mut. Life Ins. Co.*, 170 F.3d 885, 990 (10th Cir. 1999); *Smith v. Provident Bank*, 170 F.3d 609, 613 (6th Cir. 1999); *Enron*, 284 F. Supp. 2d at 681-82 (holding civil conspiracy claim based upon Texas law preempted).
124. *Pane v. RCA Corp.*, 868 F.2d 631, 635 (3d Cir. 1989); *Varhola v. Doe*, 820 F.2d 809, 817 (6th Cir. 1987).
125. *See* *Crowley v. Corning*, 234 F. Supp. at 228.
126. ERISA section 405, 29 U.S.C. § 1105.
127. *See, e.g. Sprint Third Amended Complaint, Claim V*, ¶¶ 127-133. The complaint alleges, *inter alia*, that Sprint is liable as a co-fiduciary because the actions of its directors and officers "are attributable to Sprint" (*Id.* ¶ 131(d)).
128. *See, e.g., American Fed. of Unions v. Equitable Life Assur. Soc.*, 841 F.2d 658, 665 (5th Cir. 1988).
129. *Crowley v. Corning, Inc.*, 234 F. Supp. 2d at 228 (dismissing claim against plan sponsor on grounds there were no allegations that it had de facto control over plan fiduciaries).
130. *Howell v. Motorola*, slip opinion at 12.
131. ERISA § 405, 29 U.S.C. § 1105.
132. *Id.*
133. *Henry v. Champlain Enterprises, Inc.*, 288 F. Supp. 2d 202, 222 (N.D.N.Y. 2003) ("Section 1105(a) may only be invoked against a fiduciary").
134. *See, e.g., In re Reliant Energy Litig.*, No. H-02-2051 at 16 (S.D. Tex. Filed Jan. 30, 2004).
135. *Henry v. Champlain Enterprises, Inc.*, 288 F. Supp. 2d at 223.
136. 29 U.S.C. § 1104(c).
137. 29 C.F.R. § 2550.404c-2(b)(1)(viii).
138. 29 C.F.R. § 2550.404c-1(b)(1)(viii).
139. *Enron Amicus Br.*, at 37, citing letter from Pension and Welfare Benefits Administration, U.S. DOL to Douglas O. Kant, 1997 WL 1824017 at 2 (Nov. 26, 1997) ("The responsible plan fiduciaries are also subject to ERISA's general fiduciary standards in initially choosing or continuing to designate investment alternatives offered by a 404(c) plan."): 140. H.R. CONF. REP. NO. 1280, *reprinted in* U.S.C.C.A.N. at 5086.
141. 74 F.3d 420 (3d Cir. 1996).
142. 74 F.3d at 445-46.
143. *Enron*, 284 F. Supp. 2d at 576-79.
144. *Allison v. BankOne-Denver*, 289 F.3d 1223, 1238 (10th Cir. 2002); *In re Unisys Savings Plan Litig.*, 74 F.3d 420, 446 (3d Cir. 1996).
145. *In re Sprint Corporation ERISA Litig.*, *supra* at 19.

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The Future of Loss Causation: Pleading Manipulative and Deceptive Schemes to Avoid Dismissal

By Michael L. Cypers, John M. Landry, and William H. Forman

Courts continue to develop and refine the requirements for pleading loss causation in Rule 10b-5 actions. Among the various issues that arise, one concerns whether a plaintiff need only allege that the defendant's material misrepresentations or omissions artificially inflated the price of the security at the time of purchase. In a recent decision, *Broudo v. Dura Pharmaceuticals, Inc.*,¹ the Ninth Circuit answered this question in the affirmative. In contrast, several other circuits hold that an allegation of price inflation, standing alone, is insufficient. They require a plaintiff to also allege facts showing that a subsequent event triggered a decline in the market price of the security.² This typically takes the form of a public disclosure of information that leads the market to appreciate the

true value of the security.

The United States Supreme Court has granted certiorari in *Broudo* and will resolve the loss causation issue as presented by that case. The pleading issue framed in *Broudo* is a narrow one: Whether an allegation of price inflation due to the alleged misstatement or omission at the time of purchase alone is sufficient.

This article does not consider whether *Broudo* is correctly decided. But even if *Broudo* is reversed, the debate over the role of loss causation as a pleading requirement will continue to manifest itself in other ways. Already, several recent decisions from the

Southern District of New York, following the Second Circuit's adoption of the more restrictive approach in *Emergent Capital Investment Management, LLC v. Stonepath Group, Inc.*,³ suggest that courts that are reluctant to dismiss securities actions at the pleading stage may be willing to accept imaginative theories of liability. These decisions likely foreshadow what will be the "post-*Broudo*" generation of loss causation cases, providing an opportunity to see the fault lines in the future loss causation debate.

This article first describes the present state of the law regarding the pleading of loss causation, particularly the practical impact of the more restrictive rule, i.e., the need to plead that the effect of the alleged material misrepresentation or omission was eliminated by a subsequent disclosure that triggered a stock price decline. Examining the *Emergent Capital* decision, the article then shows how that case adopts this rule but, upon closer inspection, also opens the door to theories of Rule 10b-5 liability that arguably do not depend on the effect of any specific misrepresentation or omission at the time of purchase.

The article examines how district courts responding to

Emergent Capital have seized on the distinction between 10b-5 violations based on alleged material misrepresentations and omissions and those based on so-called manipulative and deceptive "schemes" to defraud. These cases effectively circumvent the stricter pleading requirements by (1) inferring economic loss when the basis of liability rests on an alleged market manipulation scheme; or (2) inferring a sufficient nexus between an actual decline in the market price of a security and a violation when the basis of liability rests on an alleged deceptive scheme, and any alleged misrepresentations or omissions are deemed to be part of that scheme.

Two Approaches to Loss Causation

A private plaintiff must plead two causal elements to state a claim for damages under Rule 10b-5. The first, transaction causation, requires facts showing that the alleged fraud induced the plaintiff to enter into the transaction.⁴ It is analogous to a showing of reliance under the common law of fraud.⁵ While transaction causation is essential, it does not preclude the possibility that the plaintiff's alleged investment loss was caused by risks having nothing to do with the matters allegedly misrepresented or omitted by the defendant.⁶ What is also required is loss causation—facts showing that the fraud that induced the plaintiff to enter the transaction also caused the transaction to be a losing one.⁷

There are many articulations—some exceedingly abstract—of the loss causation element, including the oft-quoted phrase that the fraud must "touch ... upon the reasons for the investment's decline in value."⁸ More concretely, "the plaintiff must allege that it was the very facts about which the defendant lied which caused its injuries."⁹ The concept of loss causation is broad and flexible enough to be employed by some courts in a role analogous to proximate causation in tort law, with a focus on whether the causal nexus between the fraud and the alleged harm was sufficiently "foreseeable" or "direct," or whether the harm is more properly considered the result of intervening causes unrelated to the fraud.¹⁰

As mentioned above, two distinctly varying approaches to pleading loss causation in the fraud-on-the-market context have developed. The more liberal approach, embraced most notably by the Ninth Circuit in *Broudo*, focuses on the effect of the alleged misstatement or omission on the market price of the security at the time of purchase.¹¹ A plaintiff need only allege, as a conclusion, that the market price of the security at the time of purchase was overstated and that the alleged misstatement or omission caused the inflation.¹²

In *Broudo*, for instance, plaintiffs claimed that Dura Pharmaceuticals, Inc. (Dura) falsely suggested in public statements the imminent FDA approval of a new delivery system for asthma medicine and falsely touted rising sales of its antibiotic. On February 25, 1998, the last day of the

Under Rule 10b-5, a plaintiff must plead both transaction causation and loss causation.

alleged class period, Dura issued a press release disclosing that it expected lower-than-forecasted revenues and earnings due to slower-than-expected antibiotic sales. The price of Dura's shares immediately declined. The press release, however, said nothing about FDA nonapproval of the asthma treatment, a fact that was only first publicly disclosed in November 1998, eight months after the close of the class period. Plaintiffs, however, sought to premise liability on, and to recover losses attributable to, Dura's alleged misstatements concerning both sales of the antibiotic and FDA approval of the asthma treatment. The district court, applying the more restrictive approach, dismissed the claim as to the asthma treatment-related misstatements, observing, "The SAC does not contain any allegations that the FDA's nonapproval [of the asthma treatment] had any relationship to the February price drop." *Broudo*, 339 F.3d at 937-38. In reversing, the Ninth Circuit applied the purchase-time inflation test and eschewed any need for the plaintiffs to plead a disclosure relating to the asthma treatment and a resulting price drop. It specifically commented that the *Broudo* complaint would not survive the "less favorable" approach of several other circuits.¹³

In contrast, a more restrictive approach advanced by the Third and Eleventh Circuits, among others, holds that a plaintiff must allege not just a purchase at an artificially inflated price due to the alleged fraud, but facts showing that a disclosure or some other subsequent event lowered the security's market price, in whole or in part to reflect the true facts concealed by the fraud.¹⁴ The Third Circuit in *Semerenko v. Cendant Corporation* explained: "Where the value of the security does not actually decline as a result of an alleged misrepresentation, it cannot be said that there is in fact an economic loss attributable to that misrepresentation."¹⁵ Thus, this competing approach embraces two concepts. The first is the need for the plaintiffs to suffer an economic loss, usually in the form of a decline in the market price of the security.¹⁶ As the *Semerenko* court observed, "In the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price."¹⁷ Second, the alleged actual loss must result from a disclosure of information that either reveals the truth (or the materialization of the risk) or leads the market to realize the truth allegedly concealed by the fraud.

But, regardless of the outcome of *Broudo*, there are pleading strategies and interpretations of loss causation principles independent of the issues in *Broudo*. These approaches are on display in the decisions of district courts in the Second Circuit as they have reacted to that circuit's *Emergent Capital* decision.

The Holding and Dicta of *Emergent Capital*

The Second Circuit recently adopted the more restrictive approach for pleading loss causation with its decision in *Emergent Capital*. Subsequent district court cases applying *Emergent Capital*'s holding demonstrate that this rule leaves unanswered questions regarding loss causation, and suggest

that plaintiffs can avoid certain pleading requirements of the more restrictive approach.

In *Emergent Capital*, the plaintiff sued for alleged misrepresentations and omissions in connection with its purchase of stock of Net Value Holdings, Inc. (NETV). The plaintiff claimed that, during negotiations with NETV in early 2000 while NETV's stock was trading generally between \$10 and \$20 a share, NETV misstated the size of certain assets and failed to disclose the relationship between one of NETV's principals (Panzo) and an individual (Appel) who had been barred from the securities industry for a history of engaging in so-called "pump and dump" schemes.¹⁸ After the plaintiff made a significant investment in NETV, the company's stock price steadily declined in value, ultimately trading at less than \$1 a share. Plaintiff's complaint sought to establish liability based on, among other things, the alleged omissions regarding Panzo and Appel. The plaintiff, however, did not explicitly attribute the decline in share value to these specific nondisclosures. Rather, the plaintiff—like the plaintiff in *Broudo*, a fraud-on-the-market case—contended that the omissions "induced a disparity between the price plaintiff paid for the NETV shares and their true investment quality at the time of purchase."¹⁹ The plaintiff relied on the Second Circuit's decision in *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, which appeared to find that a purchase-time price inflation allegation alone could satisfy the loss causation pleading requirement.

In a "clarification" of *Suez Equity*, the Second Circuit in *Emergent Capital* stated that an allegation of price inflation at the time of purchase is not sufficient in and of itself to plead loss causation. Although *Emergent Capital* was not a fraud-on-the-market case, the court's decision was not limited to direct-reliance cases. The court noted that the plaintiff alleged only that the Panzo and Appel omissions caused the plaintiff to incorrectly appraise the value of NETV securities and to purchase the shares at an inflated price—a price it would not have paid had it known the true facts. Finding this allegation insufficient as a matter of law, the *Emergent Capital* court stated:

[It] amounts to nothing more than a paraphrased allegation of transaction causation. While it may explain why plaintiff purchased the NETV's stock, it does not explain why it lost money on the purchase, the very question that the loss causation allegation must answer.²⁰

The court then announced that the "established" law of the Second Circuit required "that securities fraud plaintiffs demonstrate a causal connection between the content of the alleged misstatements or omissions and the 'harm actually suffered.'"²¹

Were this all there were to *Emergent Capital*, it would constitute nothing more remarkable than the Second Circuit adopting the more restrictive approach to pleading loss causation—a debate that should be definitively settled by *Broudo*. But *Emergent Capital*'s "clarification" of the Second Circuit's standard for pleading loss causation is dicta. The actual holding of *Emergent Capital* points to a post-*Broudo* world that is already in the making, where plaintiffs may seek to satisfy the

more restrictive ruling of loss causation pleading by describing defendant's conduct as a manipulative or deceptive "scheme."

In its actual holding, the court in *Emergent Capital* found that the plaintiff's allegation of a "pump and dump" scheme did adequately allege loss causation. After recounting the allegations in the complaint that *other* ventures controlled by Panzo and Appel were "pump and dump" schemes, the court concluded:

[W]e infer that Emergent alleges that NETV itself was a "pump and dump" scheme—that is, a scheme where the company principals artificially inflated NETV stock prices before "dumping" their own shares of NETV stock on the market. [citations omitted] ... Because the second amended complaint may be read as alleging that NETV was a "pump and dump" scheme, appellant has adequately alleged loss causation for the purposes of its federal securities fraud claims.²²

Emergent Capital thus reformulates what was essentially a material omissions claim—that defendants failed to disclose information about Panzo and Appel—as a claim alleging a manipulative or deceptive "scheme." The court then concludes that the element of loss causation may be inferred from

the nature of the scheme itself. In other words, the requisite decline in share price was not caused by any corrective disclosure, but by the natural effect of the scheme having run its course.

The Implications of *Emergent Capital*: Pleading Manipulative and Deceptive "Schemes" to Avoid Loss Causation Requirements

Manipulative "Schemes" and Loss Causation

Emergent Capital charts two approaches for loss causation analysis, depending on whether the claim in question is based on: (1) an alleged material misrepresentation or omission; or (2) an alleged manipulative or deceptive "scheme." These distinctions are statutory. Material misstatements or omissions are actionable under Rule 10b-5(b). Rule 10b-5(a) and (c) forbids conduct not necessarily involving misstatements or omissions:

It shall be unlawful for any person, directly or indirectly ...

(a) To employ any device, scheme, or artifice to defraud ... or,

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.²³

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The conduct proscribed by Rule 10b-5 is co-extensive with that proscribed by Section 10(b) of the Exchange Act, which provides:

It shall be unlawful for any person, directly or indirectly ... (b) To use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may proscribe as necessary or appropriate in the public interest or for the protection of investors.²⁴

In contrast to the term “deceptive” device, the term “manipulative” device has historically had a narrow definition in the case law, essentially confined to practices “such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.”²⁵

In the wake of *Emergent Capital*, at least one district court, in passing on the adequacy of loss causation allegations, has focussed on the distinction between fraud based on an alleged misrepresentation or omission and fraud based on an alleged manipulative scheme. *In re Initial Public Offering Securities Litigation*²⁶ is an IPO “laddering” case, in which plaintiffs alleged that defendant investment banks required or induced their customers to buy shares of stock in the aftermarket as a condition of receiving initial public offering stock allocations. “These prearranged purchases,” it was alleged, “created an artificial market for the securities, and caused plaintiffs to purchase at an inflated price.”²⁷ Plaintiffs thus alleged a classic manipulation scheme as the term has been defined in the case law, i.e., the conduct in question essentially amounted to price “rigging.” Plaintiffs brought two claims: one for the market manipulation scheme itself and one for alleged material misstatements and omissions that concealed the scheme. Plaintiffs alleged that the conduct at issue under both claims artificially inflated the market price of the securities at issue at the time of purchase. The court considered whether this bare allegation of price inflation was sufficient under *Emergent Capital* to satisfy the element of loss causation.

Addressing the market manipulation claim, District Judge Shira Scheindlin wrote, “*Emergent Capital* stands for the proposition that a court may not infer, on a motion to dismiss, that the inflationary effect [of a misrepresentation or omission] will dissipate” over time and thus cause the investor to suffer an actual economic loss.²⁸ But cases involving market manipulation are “different.”²⁹ The court explained, “A market manipulation is a discrete act that influences stock price. Once the manipulation ceases, however, the information available to the market is the same as before, and the stock price gradually returns to its true value.”³⁰ It offered the following as an example:

Suppose that a bank manipulates the market for a stock by engaging in “wash sales,” fictitious trading for the purpose of creating a false appearance of activity. By creating an appearance of increased trading volume, wash sales may drive up the price of a security. Once the wash sales cease, ordinary trading resumes. The spectre of wash sales may continue

to affect the stock price for some time as investors recall the recent increased activity and observe the higher price; over time, however, the security will fall back to its true investment value.³¹

Because the price disparity caused by the alleged manipulation scheme (presumably) ceased at some point after the manipulation ceased, the court found that it “may be permissible to infer that the artificial inflation will inevitably dissipate.”³² Accordingly, the court concluded, an allegation of artificial price inflation alone is sufficient to plead loss causation in market manipulation cases.³³ The court, however, went further, determining that the market manipulation scheme allegations also satisfied the loss causation element of plaintiffs’ alleged misstatement and omission claim. According to the court, the content of the alleged misstatements was essentially that the IPO market was efficient and unaffected by manipulation. Thus, the court held that the same presumption—that the alleged price inflation from the market manipulation scheme would inevitably dissipate and cause losses—applied as well to the misstatement and omission claim.³⁴

Deceptive “Schemes” and Loss Causation

In re Initial Public Offering may have limited influence. Relatively few cases so far appear to involve conduct that fits the narrow definition of a “manipulation” under the case law.

Where the holding of *Emergent Capital* might have its greatest effect is in those cases where plaintiffs have alleged a “deceptive,” as opposed to “manipulative,” scheme under Rule 10b-5(a) and (c). Like a “manipulative” scheme, a “deceptive” scheme can form the basis of liability;³⁵ but unlike “manipulative” schemes, “deceptive” schemes are essentially undefined in the case law.

A “deceptive” scheme in fact may be something different and broader than a “manipulative” scheme. This understanding was the basis for a decision in *In re Enron Corporation* that the plaintiffs had adequately alleged claims of primary liability against certain secondary actor defendants (Enron’s accountants, lawyers, and bankers).³⁶ Specifically, the court held that plaintiffs could pursue claims under Rule 10b-5(a) and (c) against investment banks and other defendants who did not make any actual misrepresentations but allegedly had assisted in structuring certain sham entities that were vehicles for Enron’s fraud. One important aspect of this decision was the court’s acknowledgment that the plaintiffs’ allegations did not fit the definition of a “manipulative” scheme.³⁷ Nevertheless, after noting that the law also imposed liability for “deceptive” schemes, the court held that the novelty of any such scheme should not bar liability.³⁸ Thus the court concluded that the allegation of a “deceptive” scheme, not defined by any examples in the case law, could form the basis of liability. In fact, the *Enron* court found that it was “irrelevant,” in light of the secondary actor defendants’ alleged involvement in structuring the Enron fraud, whether plaintiffs had alleged facts sufficient to show that defendants’ misrepresentations about Enron were actionable.³⁹

In re Enron is not a loss causation case, but it is significant in the loss causation debate in light of *Emergent Capital*.⁴⁰ After *Emergent Capital*, there is some incentive

for plaintiffs to try, where possible, to characterize misrepresentation or omission claims as schemes to defraud. At a minimum, after *In re Enron*, litigants are likely more attuned to the possibility of characterizing as “schemes” conduct that falls outside the classic definitions of manipulation.

Taken together, the *In re Initial Public Offering* and *Enron* cases provide a window into a post-*Broudo* world where plaintiffs may define a deceptive scheme to include acts of misrepresentation and omission, and thus avoid the need to plead price drops resulting from corrective disclosures. The case that best illustrates the use of the deceptive “scheme” model is *DeMarco v. Robertson Stephens Inc.*⁴¹ In *DeMarco*, plaintiffs alleged that the defendant analysts disseminated research reports and recommendations regarding a stock that were contrary to defendant’s true opinion of the stock, and that plaintiffs purchased the stock in reliance on

In *Fogarazzo*,
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loss causation.

defendant’s statements. The defendant argued that plaintiffs failed to allege loss causation because an intervening event obvious from the face of the complaint—the collapse of the telecommunications bubble—caused the decline in the stock before the material misrepresentations were revealed.

Nevertheless, the court in *DeMarco* found plaintiffs’ loss causation allegations sufficient to withstand a motion to dismiss. The court appropriated the defendants’ “bubble” argument, converting it from an intervening cause defense to evidence of the defendant’s control of the market. According to the court,

the alleged misrepresentations “inflat[ed] the bubble,” and therefore the defendant should be “held responsible when the market eventually corrects the artificially inflated price by bursting the bubble.”⁴² There was thus no need to tie the alleged loss to any corrective disclosure concerning any specific alleged misrepresentation or omission. The allegation of a “scheme” itself supplied a nexus between the loss and the alleged fraud.

Central to the *DeMarco* court’s view that the bursting of the telecommunications bubble should be seen as a result of defendant’s conduct, rather than as an independent cause of injury, was its willingness to view the case as a scheme to defraud akin to the “pump and dump” alleged in *Emergent Capital*. Although the defendant argued that a classic “pump and dump” scheme was not present because the plaintiffs had not alleged that the defendant’s rapid sale of the stock (the “dump”) caused the price of the stock to drop, the court brushed aside this distinction, finding that the plaintiffs’ allegations could at least be analogized to a “pump and dump” scheme:

Defendants are correct that “pump and dump” is not a talisman, and merely citing those words is not sufficient to allege loss causation. By the same token, however, the fact that the alleged fraud is *not* a classic “pump and dump,” but rather a variation on that theme, does not in itself mean that

plaintiffs fail to allege loss causation. The analogy to a pump-and-dump scheme is that defendants misused their status as market commentators to prop up the ... stock price until they could unload their own shares. When defendants chose to speak about [the stock], they hid their true opinion, which could have depressed the price, and lied with the intent to increase the demand for [the] stock for their own gain. The impact of defendants’ false opinions on share price is a question of fact for a jury to decide, regardless of the jargon used to describe the scheme.⁴³

The court further reinforced the analogy when it wrote, “[T]he bursting of the ... stock bubble could reasonably be construed, at least in part, as the market’s correction of an inflated stock price, pumped up in part by defendants’ false statements about its opinions.”

Some may argue that *DeMarco*’s reliance on the “pump and dump” analogy proves too much: Any action against an analyst could involve an allegation that the analyst misrepresented its true opinion of the stock in question, thus “pumping” the price. Any subsequent decline in the stock—whether or not correlated to the revelation of the analyst’s “true” opinion or to the facts underlying that opinion—could be in part an inferred consequence of the “pump” and thus satisfy the loss causation element.⁴⁴ But *DeMarco* advances the same loss causation analysis that the court in *In re Initial Public Offering* applied to the market manipulation claim in that case, and similarly provides a roadmap for avoiding the majority rule for pleading loss causation, as adopted (or restated) in *Emergent Capital*. Under the logic of these cases, as long as a misrepresentation can be characterized as a scheme to inflate or “pump” the price of a stock, it need not be alleged at the pleading stage that any subsequent decline in the price was caused by the revelation of the misrepresentation. The allegation of a decline alone—the “inevitable” consequence of “pumping”—will suffice.

While the immediate impact of *DeMarco* may not be apparent, the potential implications are significant when one considers that it is a fairly straightforward application of the holding in *Emergent Capital* that allegations of “pumping” caused by misrepresentations or omissions carry within themselves a sufficient implication of loss causation.⁴⁵

Since *DeMarco*, at least one other district court has relied on similar reasoning in denying a motion to dismiss for failure to plead loss causation. *Fogarazzo v. Lehman Bros., Inc.*,⁴⁶ also an opinion by Judge Scheindlin, involved allegations by investors in RSL Communications (RSL), a telecommunications company, that defendant stock analysts had issued “fraudulently” optimistic opinions regarding RSL, even as they actually believed that the company’s prospects were poor. The defendants moved to dismiss the complaint on the ground that plaintiffs had failed to allege that their losses were caused by the revelation of defendants’ true opinions of RSL.

The district court agreed that the defendants had not concealed any *facts* regarding RSL, and that the revelation of defendants’ “true” opinions of RSL did not cause the decline in the price of RSL’s stock.⁴⁷ Moreover, the court took pains to explain that plaintiffs’ allegations did *not* amount to “a

pump and dump scheme that would suffice to allege loss causation.”⁴⁸ The court specifically found that the plaintiffs had failed to allege that defendants could “easily manipulate the price” of the stock to facilitate any alleged scheme.

Nonetheless, the district court denied the motion to dismiss. It found that “there [was] no doubt” that the plaintiffs had adequately alleged loss causation.⁴⁹ In reaching this conclusion, the court relied on allegations that the defendants had “hyped” the securities, and in so doing had “inflated” their value.⁵⁰ The allegation of “hying” alone carried within it the necessary element of loss causation: “[L]oss was foreseeable because the misrepresentations induced plaintiffs to purchase securities at artificially inflated prices.”⁵¹ The misrepresentations thus caused the plaintiffs’ losses “even if they did not cause the decline in the value of the securities.”⁵² Judge Scheindlin wrote, “the [defendants], knowing that RSL was actually in decline, inflated the price of RSL shares and then worked doubly hard to conceal or obfuscate the meaning of every fact that would have revealed that decline to the investing public. How could the [defendants] not have foreseen the loss to investors?”⁵³

Despite Judge Scheindlin’s ostensible desire to cabin the effects of a “scheme” analysis, in the end she succumbs to it: The “hying” element of *Fogarazzo* is indistinguishable from the “pumping” element of *DeMarco*, both as to content and to the effect each allegation has of permitting the court to infer a causal connection between the misrepresentation and the loss. By holding that misrepresentations that inflate the market price of a security at the time of purchase also contain the seeds of inevitable loss, *Fogarazzo* imports the notion from *In re Initial Public Offering* that a correction in price, even if not the alleged result of the misrepresentation, is somehow inevitable.

Conclusion

Whatever the outcome in *Broudo*, *In re Initial Public Offering*, *DeMarco*, and *Fogarazzo* articulate theories of loss causation independent of *Broudo*. These recent developments in the Second Circuit indicate that a new generation of analyses are forming where the loss causation inquiry, beginning at the pleading stage, will focus less on the presence and effect of any corrective event and more on whether the defendant’s alleged conduct may be characterized as a manipulative or deceptive scheme. Questions about what constitutes a deceptive scheme and whether such schemes inherently cause loss may form the next round in the loss causation debate. *

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1. 339 F.3d 933 (9th Cir. 2003), *cert. granted*, 124 S. Ct. 2904 (U.S. June 28, 2004).

2. *See, e.g., Semerenko v. Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000); *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1446-48 (11th Cir. 1997). Assuming that an alleged corrective disclosure is required, that raises other issues, including whether the form and con-

tent of the disclosure effectively revealed the earlier-concealed information. *See In re Electronic Data Sys. Corp. Sec. and “ERISA” Litig.*, 298 F. Supp. 2d 544 (E.D. Tex. 2004) (loss causation adequately alleged notwithstanding lack of explicit statement in press release that revenue loss was due to allegedly concealed problems with government contract, where subsequent market analysts’ reports connected the two events). That issue is not addressed by this article.

3. 343 F.3d 189 (2d Cir. 2003).

4. *Robbins, supra*, 116 F.3d at 1447.

5. *Id.*

6. As explained by Judge Posner in *Bastian v. Petren Resources Corporation*, 892 F.2d 680, 685-86 (7th Cir. 1990), a damages award issued upon a showing of transaction causation alone would transform the defendant into an insurer of all risks assumed by the investor whether or not those risks were concealed by the fraud.

7. *See id.* at 684. Although originally adopted from common law tort principles, Congress codified loss causation in 1995 as an element of a Rule 10b-5 private right of action: “In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.” 15 U.S.C. § 78u-4(b)(4).

8. *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981).

9. *Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 648 (7th Cir. 1997).

10. *See, e.g., Suez Equity Investors L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 96 (2d Cir. 2001).

11. Decisions by the Eighth Circuit may be read as setting forth a similar pleading requirement. *See Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 832 (8th Cir. 2003) (“[P]laintiffs were harmed when they paid more for the stock than it was worth. This is a sufficient allegation.”).

12. *See Broudo*, 339 F.3d at 938. In an earlier decision, the Ninth Circuit articulated the bases for its approach by reference to the following propositions: (i) damages are properly calculated as “the difference between the purchase price and the [true] value of the stock at the date of purchase;” (ii) “market forces operating on the misrepresentation” can cause losses even to investors who resell before any market price changes due to any corrective disclosure; and (iii) although it is some evidence of the true value of the stock, “the post-disclosure price is not a measure of pre-disclosure value.” *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996) (emphasis added) (citations omitted).

13. *See id.* at 938 n.4. Although the pleading burden imposed by the purchase-time inflation test is slight, actually proving that the alleged misstatement in fact caused the alleged market price increase can still pose difficulty. *See, e.g., Winkler v. NRD Mining, Ltd.*, 198 F.R.D. 355, 370 (E.D.N.Y. 2000) (granting directed verdict where evidence showed that market price increase was due not to defendant’s alleged misleading press release but to another press release, not alleged to have been misleading, issued by the defendant at about the same time).

14. *See Semerenko*, 223 F.3d at 185; *Robbins*, 116 F.3d at 1446-48. This approach is now also explicitly embraced by the Second Circuit as discussed in section III, *infra*.

15. 223 F.3d at 185.

16. Although this standard is phrased in terms of a decline in stock price, a plaintiff presumably can also meet it if he can allege facts showing that the increase would have been greater but for the corrective disclosure. *See Gebhardt*, 335 F.3d at 831.

17. 223 F.3d at 185.
18. A “pump and dump” has been described as a scheme whereby “persons holding certain securities fraudulently inflate their price (the ‘pump’) in order to sell at an artificial profit (the ‘dump’).” *United States v. Salmonese*, 352 F.3d 608, 612 (2d Cir. 2003).
19. 343 F.3d at 198.
20. *Id.* at 198. Though it is by no means clear from the opinion, it seems that the plaintiff was unable to allege that the NETV stocks declined upon revelation of the material omission because the decline in price was preceded and caused by the collapse of the Internet bubble. *Id.* at 197.
21. *Id.* at 199.
22. *Id.* at 197-98.
23. 17 C.F.R. § 240.10b-5(a) and (c).
24. 15 U.S.C. § 78j(b).
25. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195, 199 n.21 (1976)).
26. 297 F. Supp. 2d 668 (S.D.N.Y. 2003).
27. *Id.* at 669.
28. *Id.* at 674 n.29.
29. *Id.* at 674.
30. *Id.*
31. *Id.*
32. *Id.*
33. Presumably, however, a plaintiff who resells the security before the conclusion of the alleged manipulation scheme does not suffer any impact. See *Arduini/Messina v. National Med. Financial Serv.*, 74 F. Supp. 2d 352, 361-62 (S.D.N.Y. 1999) (“[A]ny drop in [issuer’s] stock price as a result of the fraud about which plaintiffs complain would not have been felt ... prior to the collapse of the market manipulation scheme.”).
34. *Id.* At 675.
35. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-53 (1972) (holding that while subsection (b) of Rule 10b-5 provides a cause of action based on the “making of an untrue statement of a material fact and the omission to state a material fact,” subsections (a) and (c) “are not so restricted” and allow suit against defendants that participated in “a ‘course of business’ or a ‘device, scheme or artifice’ that operated as a fraud” on sellers or purchasers of stock even if such defendants did not make a materially false or misleading statement or omission).
36. *In re Enron Corp. Secs., Deriv. & ERISA Litig.*, 235 F. Supp. 2d 549 (S.D. Tex. 2002).
37. *Id.* At 577-81.
38. *Id.*
39. *Id.* at 689.
40. Consistent with the implications of her holding, in a subsequent decision in the *Enron* case, District Judge Melinda Harmon addressed Merrill Lynch’s motion to dismiss on the ground that plaintiffs had failed to adequately plead loss causation. In denying the motion, she stressed that the essence of the allegations against Merrill Lynch were in the nature of a scheme to defraud, that the scheme “artificially inflated the value of Enron securities ... [that] induced the plaintiffs to purchase the securities at a highly inflated price until the Ponzi scheme bubble inevitably broke.” See *In re Enron Corp. Secs. Deriv. & ERISA Litig.*, 310 F. Supp. 2d 819, 832 (S.D. Tex 2004) (emphasis added).
41. 2004 U.S. Dist. LEXIS 265, Fed. Sec. L. Rep. (CCH) P92,662 (S.D.N.Y. January 9, 2004).

42. *Id.* at *32.
43. *Id.* at *35 (emphasis in original).
44. *Id.*
45. In contrast to *DeMarco* stands *In re Merrill Lynch & Co. Research Reports Securities Litigation*, 289 F. Supp. 2d 416 (S.D.N.Y. 2003), where the court found that plaintiffs had failed to allege loss causation because the burst of the Internet bubble severed any connection between the alleged misrepresentations and the alleged losses suffered. *Merrill Lynch* has been appealed. *In re Merrill Lynch & Co. Research Reports Securities Litigation*, (2d Cir., No. 03-9286).
46. 2004 U.S. Dist. LEXIS 9193 (S.D.N.Y. May 21, 2004).
47. *Id.* At *40-41.
48. *Id.* at *45, n.113.
49. *Id.* at *40.
50. *Id.* at *42-43, *49.
51. *Id.* at *39.
52. *Id.* at *40.
53. *Id.* at *49-50 (emphasis in original).

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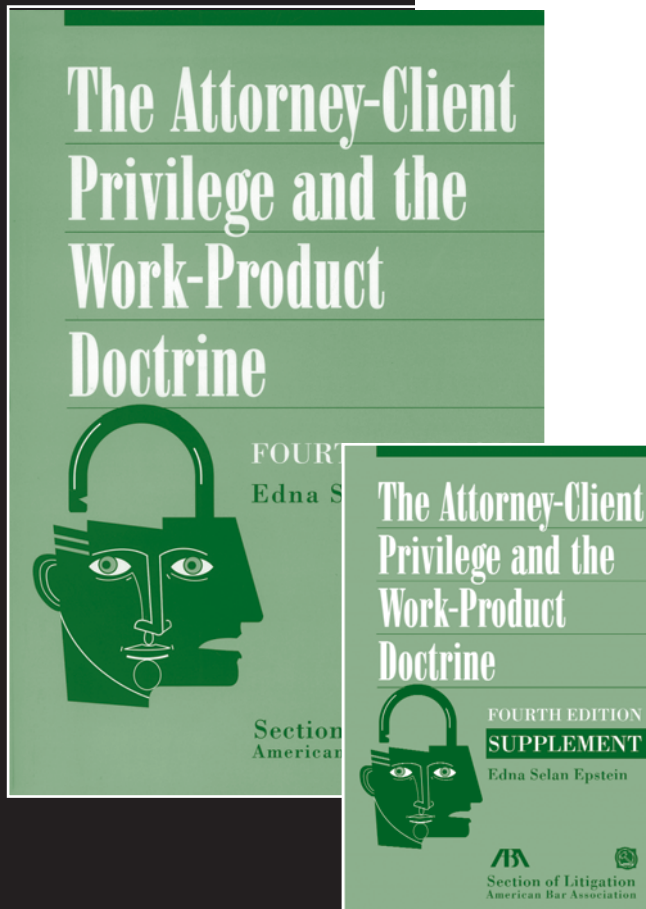
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OPINION

CFTC Speaking Orders: Are They Lawful?

By Charles R. Mills and Richard E. Nathan

Since 1994, the Commodity Futures Trading Commission (CFTC or Commission) routinely has settled administrative proceedings through the entry of speaking orders. The term “speaking order” is used by the Commission itself and is derived from an order’s inclusion of elaborate findings of fact and conclusions of law that greatly exceed the content legally required to enter and impose consensual findings and sanctions.¹

The Commission uses speaking orders to give public notice of its interpretation of the Commodity Exchange Act (CEA) and the Commission’s regulations and of conduct the Commission considers unlawful. This presumably allows members of the futures and derivatives industry to conduct their operations in compliance with the Commission’s expectations and views.

In practice, speaking orders do, indeed, command the attention of industry participants and their counsel. When advising their clients, prudent lawyers normally will give great weight to any expression of Commission views—even if they believe the Commission to be mistaken. And industry participants will typically alter their business practices to conform to the Commission’s pronouncements, regardless of almost any other consideration.

In view of the deference they are given, it is appropriate to consider whether speaking orders are in fact sound vehicles for the promulgation of standards to which the public is expected to

conform. We think they are not and that there are substantial reasons why their use should be abandoned.

Notwithstanding the Commission’s worthy objectives, speaking orders too often spawn unnecessary confusion and controversy. Much of this owes to the flawed process for their issuance, which generally involves the Commission’s uncritical acceptance of the Division of Enforcement’s one-sided view of the relevant facts and law. In the context of a settlement, the Commission acts without meaningful debate or the benefit of a fully developed record and with little or no apparent consideration of a speaking order’s implications beyond the enforcement matter at hand. In a related context, the Commission has acknowledged that it “is not well positioned to adjudicate factual disputes in the absence of a fully developed factual record.”² The Commission is equally ill-advised to attempt to formulate important legal positions and

other statements of policy without hearing and considering all relevant viewpoints.

In our opinion, interpretive releases that reflect the full range of relevant staff (and possibly public) opinion are a far better vehicle for the formulation and expression of Commission policy. The Commission has relied on such releases in the past.³ Although they, too, can spawn intense debate within the industry, the deliberative and inclusive procedure leading to their adoption—particularly when contrasted to the narrow enforcement context in which speaking orders are produced—tends to promote (although not assure) a more thorough and probing evaluation of the issues.

The negotiation and preparation of speaking orders also are a needless drain on the Commission’s limited enforcement resources, requiring a substantial investment of staff time and effort when simple findings and conclusions would suffice. This drain on resources is especially wasteful since detailed factual findings in a particular case have no legal effect on anyone but the parties involved. Indeed, speaking orders normally state that they may not be relied upon in third-party proceedings.

Furthermore, speaking orders address only issues that happen to arise in the context of a particular enforcement proceeding, and only those that a respondent is willing to settle. As a result, it is entirely fortuitous if a speaking order concerns an important issue of broad public interest—one worthy of the substantial time and attention that might profitably be devoted to other matters.

The use of speaking orders can also undermine fundamental fairness in administrative proceedings. Particularly in partial settlement of multiparty cases, there is a substantial question whether the Commission complies with applicable statutory and constitutional standards in the preparation, consideration and adoption of its speaking orders. Indeed, the Commission seems frequently to ignore the due process rights of nonsettling parties, expressing its prejudgment of issues as to which no evidence has been adduced and no arguments heard, and permitting its enforcement staff to address the Commission regarding their view of the merits of the ongoing case without meaningful regard to the separation of function’s requirements of the Administrative Procedure Act and the Commission’s own rules.

The History of Speaking Orders

The CFTC’s use of speaking orders follows a similar practice of the Securities and Exchange Commission in settling its administrative proceedings. The first CFTC speaking order identified as such was issued in the settlement of *In re BT Securities Corporation*, CFTC Doc. 95-3 (Dec. 22,

Are speaking orders sound vehicles for the promulgation of standards to which the public is expected to perform?

1994), which was issued concurrently with an order of the SEC resolving securities law violations arising from the same operative facts.⁴ Approximately six months later, the CFTC's speaking order in *In re MG Refining & Marketing, Inc.*, CFTC Docket No. 95-14 (July 27, 1995), generated significant controversy regarding whether the order's discussion of the indicia of futures contracts and its implications with respect to the CFTC's authority over over-the-counter derivatives reflected a change in the CFTC's position. The *MG Refining & Marketing, Inc.* order drew fire from the petroleum trade, the derivatives industry, academics and *The Wall Street Journal*⁵ and resulted in the CFTC's Chairperson writing a letter to the *Journal* addressing the criticisms and contending that the order was consistent with the Commission's prior position.

Few, if any, speaking orders since have involved such publicized debate, but many have caused consternation for industry participants and members of the commodity bar attempting to decipher the Commission's position on the law. This is especially the case when the Commission has announced a novel legal position through a speaking order.⁶

The Legal Status of Speaking Orders

Speaking orders have an ambiguous legal status. Although they appear to reflect the Commission's carefully considered views, by their terms they are not intended to be binding legal precedent. Nor are they issued as a result of procedures appropriate to establish binding legal precedent. As each order states, it is issued without conducting any hearing to determine the truth of the factual findings made or the merits of enunciated principles of law. Each order explains that the settling respondent consented to the order solely for purposes of that proceeding and without admitting or denying the truth of the findings made. Moreover, the orders typically declare that their findings are not binding on any other person or entity.

It is not surprising, therefore, that some courts have found that a consent order should have little precedential weight.⁷ Yet the SEC and other courts have sometimes attributed significant weight to SEC speaking orders. Indeed, the SEC has opined that its speaking orders may be considered "as authoritative as opinions in [contested] cases."⁸ Further, the D.C. Circuit has observed that "the [SEC's] construction of the securities laws in settled cases as well as litigated ones is entitled to great weight."⁹ More accurate and appropriate by far is the CFTC's observation, made prior to its use of speaking orders, that "settlements are not precedential in the ordinary sense, [although] they are some indication of the Commission's" approach.¹⁰

Prudential Concerns That Militate Against the Use of Speaking Orders

Typically, once a settling respondent has reached terms with the Division of Enforcement, the Division will prepare a draft of the speaking order it proposes to submit to the Commission. The draft sets forth the Division's view of the evidence, which may well be identical to the allegations contained in the Division's complaint. It ignores infirmities in

the Division's proof and the existence of legal and factual defenses that might compel a different outcome if the matter were adjudicated. And, in the authors' experience, the Division is generally unwilling to accept significant changes to its proposed speaking order, requiring the respondent either to acquiesce in the Division's point of view or bear the substantial cost and inconvenience of protracted litigation.¹¹

For their part, settling respondents are frequently ambivalent about, and therefore do not contest, the specific phrasing or content of the draft order. Findings of fact and conclusions of law regarding the conduct of other parties often are unopposed where they do not affect the settling respondent's interests.¹²

In any event, the drafts prepared by the Division to which respondents have agreed are routinely approved and become the orders of the Commission. The authors are not aware of any evidence that the findings and conclusions they contain are substantially debated by the Commission before being issued in its name. Indeed, to the extent that the Division is permitted to utilize the seriatim procedure of Commission Rule 140.12, 17 C.F.R. § 140.12, the order drafted by the Division may well be approved without any Commission deliberations.

Thus, unlike the processes for adjudication and rulemaking, the process for speaking orders lacks any checks or balances serving to ensure rigorous analysis and the fullest consideration of possible effects and consequences. In adjudicated cases, findings and conclusions are born of a vigorous adversary process in which the merits of factual and legal contentions are thoroughly tested and debated. In rulemaking, all elements of the Commission's staff and all interested parties may participate, offering debate with the broadest possible presentation of views regarding the effects and implications of any particular agency proposal.

The decisional process for entering speaking orders not only lacks those safeguards, but, to the contrary, is rooted in the natural bias that the Division of Enforcement will inevitably bring to the process as an advocate:

A man who has buried himself in one side of an issue is disabled from bringing to its decision that dispassionate judgment which Anglo-American tradition demands of officials who decide questions. *The Final Report of the Attorney General's Committee on Administrative Procedures* at 56 (1941) (Final Report) (which guided the development of the Administrative Procedure Act (APA)).¹³

Eliminating such bias from administrative decisional process was one of the principal impetuses for the separation-of-

The process for speaking orders lacks checks and balances that would assure rigorous analysis.

functions requirements of the APA.

Evidence of the unsoundness of speaking orders is found in the numerous Commission opinions in fully litigated cases that have rejected the Division's factual allegations and legal theories.¹⁴ Had any of these cases been resolved through settlements, the speaking orders issued by the Commission would have set forth findings of fact and conclusions of law far different than those reached by the Commission after the views of the Division were vigorously contested.

Legal Infirmities of Speaking Orders in Multiparty Cases

Prejudgment and Bias

When the Commission settles an administrative proceeding, it performs both prosecutorial and quasi-judicial functions. It acts as a prosecutor when it supervises the Division's negotiation of settlement terms; it acts as a judicial decision maker when it enters an order stating findings and conclusions, imposing consensual sanctions and dismissing the proceeding against the settling respondent.

While the concurrent performance of these apparently conflicting responsibilities is not inherently unconstitutional,¹⁵ it presents a risk that prosecutorial bias may unconstitutionally infect quasi-judicial determinations.¹⁶ The Commission must avoid even the appearance of such impropriety, particularly when the proceeding will continue against nonsettling respondents.

The Commission falls short of that objective when it issues speaking orders setting forth the

Division's views as "findings" of the Commission concerning the conduct of nonsettling respondents. The rights of nonsettling respondents are further impaired when the Commission "orders" a settling respondent to comply with settlement terms that materially interfere with the ability of nonsettling respondents to obtain cooperation and testimony from the settling respondent that may dispute the "findings" the Commission has made.

Speaking orders violate constitutional and statutory rights of nonsettling parties to a fair adjudication when they contain definitive findings that either expressly or impliedly find that a nonsettling party violated the law. This occurs most often when the Commission settles with a corporate respondent, finding the corporation liable for the acts of its correspondent agents and, although those agents have admitted nothing and had no hearing, gratuitously enters detailed "findings" about their conduct and "conclusions" that they violated the CEA.¹⁷ The Commission's prejudgment of a nonsettling party's guilt, before the presentation of any evidence against him or her, and without a meaningful opportu-

nity to be heard, undermines the integrity of the Commission's adjudicative process, is fundamentally unfair and a denial of due process.

Nor is it constitutionally permissible for the Commission, acting in its quasi-judicial capacity, to issue orders that clearly favor one party (the Division) over others (all nonsettling respondents). Yet that is the effect—if not the purpose—of boilerplate language that every speaking order contains. All speaking orders expressly require a settling respondent to cooperate with the staff in its further prosecution of the proceeding. They also expressly forbid a settling respondent publicly to dispute the findings of fact the speaking order contains.

To be sure, an exception is stated with regard to the settling respondent's "testimonial obligations" and its right to take factual or legal positions in other proceedings. As a result, a settling respondent may testify truthfully in any proceeding and may take positions contrary to the Commission's findings in third-party litigation.

These exceptions implicitly recognize that a settling respondent who consented to Commission "findings" without admitting or denying their truth (perhaps only to avoid the substantial costs and other burdens of further proceedings) may well be in a position to controvert those "findings" through truthful sworn testimony given on behalf of nonsettling respondents. But in the authors' experience, these exceptions do not negate the inevitable effect of the Commission's order—raising a not unreasonable fear of retribution and possible sanctions if the settling respondent should cooperate with nonsettling respondents, by providing information and giving testimony casting doubt on the Division's allegations and the Commission's findings.

Of course, it is proper for the Division to extract a promise of future cooperation as a condition of its agreement to recommend a settlement to the Commission. Such an agreement, appropriately phrased, without more, would not interfere with a settling respondent's ability to cooperate with anyone else. It may also be reasonable for the Commission to take action to ensure that its public announcement of the terms of a settlement will not be accompanied in the press by a settling respondent's denial of wrongdoing and dispute of findings to which he or she has consented. But any action the Commission may take for such a purpose should be drawn as narrowly as possible. It simply does not follow from a need to address this legitimate concern that the Commission may broadly restrict free speech and communication regarding matters that remain in dispute, issuing an order that provides substantial advantages to the Division and impairs the ability of nonsettling respondents to prepare and present their defense.

The Supreme Court has made clear that "a biased decisionmaker [is] Constitutionally unacceptable,"¹⁸ and that "an administrative remedy may be inadequate where the administrative body is *shown to be biased* or has *otherwise predetermined the issue before it*."¹⁹ In determining the fairness of adjudicatory proceedings, the Commission is held to a high standard—"our system of law has always endeavored to prevent even the probability of unfairness."²⁰

A speaking order finding a nonsettling party in violation of the law cannot satisfy the standard for fairness and due process.

A speaking order that finds a nonsettling party to be in violation of the law cannot possibly satisfy the standard for fairness and due process to which the Commission is held. Impermissible prejudgment exists wherever “a disinterested observer may conclude that the [decision maker] has in some measure adjudged the facts as well as the law of a particular case in advance of hearing it.”²¹ When a Commission speaking order makes findings of violations with respect to the conduct of nonsettling parties, a disinterested observer not only *may*, but *must* conclude that the Commission has “in some measure adjudged the facts as well as the law ... in advance of hearing it.”²²

Relevant precedents support this conclusion. The Court of Appeals for the District of Columbia Circuit overturned a rule of the Federal Trade Commission where a Commissioner who participated in adoption of the rule had earlier given a luncheon speech and press interviews revealing his bias and prejudgment.²³ Under this precedent, if any CFTC Commissioner gave a speech prior to the agency’s adjudication in a nonsettling party’s case, expressing his or her views regarding the facts and legal significance of that party’s conduct on terms identical to the definitive findings and conclusions of a speaking order, a judicial finding of bias and prejudgment would be inevitable. The same result must surely obtain when a majority or even all of the Commission members—not merely one—have subscribed to a formal order, on the public record, stating their findings of facts and the determinative law before hearing evidence and arguments of a nonsettling party.

Prohibitions of Ex Parte Communications

Section 5(c) of the APA, as codified, 5 U.S.C. § 554(d), and Commission Rule 10.9, 17 C.F.R. § 10.9, prohibit ex parte communications between enforcement personnel and the Commission regarding the disposition of any case. Section 554(d) provides in pertinent part:

An employee or agent engaged in the performance of investigative or prosecuting functions for an agency in a case may not, in that or a factually related case, participate or advise in the decision, recommended decision, or agency review ... except as witness or counsel in public proceedings.

Commission Rule 10.9 similarly provides:

No ... employee ... of the Commission who is engaged in the performance of ... prosecuting functions in connection with any proceeding shall, in that proceeding ... advise in the decision of ... the Commission except as witness or counsel in the proceeding, without the express written consent of the respondents in the proceeding.

Consistent with these provisions, Commission orders instituting proceedings typically direct that, in the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecutorial functions in that or any factually related proceedings will be permitted to participate or advise in the deci-

sion of that proceeding except as a witness or counsel.

To address these concerns, when an offer of settlement and proposed speaking order is presented for Commission consideration, the Commission’s rules effectively require that the settling party consent to the Division’s presentation of the offer and order to the Commission²⁴ and formally waive any objection to participation in the Commission’s decision by the members of the Commission’s staff.²⁵ As a result, once the Division recommends the Commission’s adoption of the agreed form of speaking order, the staff members who investigated and prosecuted the matter are free to discuss its merits and advocate its adoption to the Commission without regard to otherwise applicable separation-of-functions or other due-process considerations.

There is nothing inherently wrong with these procedures or the rules on which they are based, provided they do not materially involve and prejudice nonsettling parties’ rights. But the Commission and the Division of Enforcement have often used settlements to obtain the consent and waiver of a settling respondent to findings of fact, conclusions of law and staff participation regarding the conduct of other respondents who will remain in the case. Those findings and conclusions effectively foreclose any chance of a successful defense by those respondents unless they can persuade the Commission to enter a subsequent ruling that directly contradicts the Commission’s findings and conclusions in the speaking order.²⁶

Such process violates applicable separation-of-functions provisions and is a denial of due process. The nonsettling parties have given no consent to the staff’s presentation or to its participation in the Commission’s consideration and disposition of a speaking order addressing their conduct and affecting their rights. Nor have they waived the prohibition against ex parte communications that will necessarily affect the Commission’s ultimate decision in their case.

Findings and conclusions regarding the allegations against non-settling respondents are in no sense necessary to resolve a case against a consenting party. They are appropriately determined only through adjudication. Accordingly, the Commissioners should not accept memoranda from, or hold meetings with, enforcement staff involving an ex parte presentation that may influence the Commission’s performance as a decision-maker with regard to the conduct of the nonsettling respondents.

Section 554(d) was enacted precisely to prevent ex parte advocacy. As the Final Report of the Attorney General’s Committee observed:

It is clear that when a controversy reaches the stage of hearing and formal adjudication the persons who did the actual work of investigating and building up the case should play *no part* in the decision. ... *Clearly the advocate’s view ought to be presented publicly and not privately to those who decide.*²⁷

Thus, the House and Senate Committees each made clear at the time the APA was enacted, “The purpose of the section [now 5 U.S.C. 554(d)] is to assure that *no investigating or prosecuting officer shall directly or indirectly in any manner influence ... the operations of ... deciding officers*, except as a

participant in public proceedings.”²⁸

The SEC has acknowledged the severe risk of improper decisional influence and related violations of the separation-of-functions requirement with respect to partial settlements of multiparty cases. In *In re The Stuart-James Co., Inc.*, 50 S.E.C. 468 (1991), the SEC considered the applicability of APA section 554(d) to a situation in which the enforcement staff had proposed a settlement with only one of several respondents. The SEC recognized, “[I]n a multiparty ... permitting ex parte contacts concerning a pending settlement ... poses a danger of abuse.” It consequently held, “Discussions between [the SEC] and the staff litigating a multiparty proceeding should be carefully circumscribed, so as to prohibit improper advice or influence with respect to a decision in the case against non-settling respondents.”²⁹ Accordingly, while

the SEC held that the separation-of-functions provision of section 554(d) “should not be read to bar discussion of a settlement proposal in a multiparty proceeding,” it emphasized that this would be true *only* “if the discussion does not involve advice or participation in decisionmaking as to the other nonsettling parties.”³⁰

Conclusion

The Commission’s use of speaking orders to announce findings and legal positions without the benefit of a process that ensures full consideration of competing views and collateral effects is at best a very poor approach to the formulation of policy. At worst, for the reasons

discussed above, it is a procedure that denies due process to respondents who choose to defend against the Division’s allegations rather than settle on terms demanded by the Division.

The foregoing authorities counsel that it is fundamentally unfair and a denial of due process for the Commission, performing in its role as a decision maker, *ever* to permit the Division to argue ex parte the merits of its administrative cases against absent and nonconsenting parties, especially where, as in speaking orders, this formally crystallizes in the Division’s favor the Commission’s characterization of the relevant facts and law. Nevertheless, the Commission routinely permits the personnel involved in the investigation and prosecution of a case to prepare the Commission’s findings and conclusions in speaking orders that recite the culpability of nonsettling and nonconsenting respondents, often in language that tracks the Division’s complaint. This joining of decisional and prosecutorial functions is inconsistent with the conduct of fair proceedings against nonsettling respondents.³¹

The power to investigate and prosecute violations of law involves an awesome responsibility. The costs that may be imposed and the damage that may be done to reputations, careers and livelihoods require the exercise of great care and caution. The Commission must be sensitive to the fact that

The process unfairly allows the Division to argue the merits of its cases against absent parties.

Authors’ Note: On Page 34 of this issue, Geoff Aronow responds, primarily arguing that speaking orders are valuable as a means to know the Commission’s thinking. He argues that an order that lacks detailed findings and conclusions would be “virtually opaque” for this purpose. We agree that publication of Commission views—even regarding narrow issues—can be a useful thing. We endorse endeavors to advise the public as often and clearly as possible of the Commission’s views on any subject within its jurisdiction. But, speaking orders are seriously flawed vehicles for that purpose and their unfair impact upon nonsettling respondents requires their abandonment.

An unchallenged wish list of findings and conclusions prepared by the Enforcement Division should not be presented as the views of the Commission. These findings and conclusions have not been critically tested or analyzed against the full evidence and countervailing legal viewpoints. The acquiescence of a respondent desperate to escape the quagmire of a Commission proceeding is no substitute for a fully developed record as a basis for Commission action. Aronow’s statement that, “there are internal procedures by which the reasoning behind the orders is vetted, including with the CFTC’s Office of General Counsel,” does not assuage our concerns that the Commissioners have no substantial role in the process and that whatever “vetting” occurs is no more than a “once over lightly.”

In any event, a desire to inform the public cannot justify insensitivity to unfairness or excuse violations of the constitutional and statutory rights of nonsettling respondents in multiparty cases. Aronow acknowledges that the settlement of multiparty cases raises fairness concerns to which the Commission and its staff must remain extremely sensitive. Yet he asserts that, “there is no evidence of actual ‘prejudgment.’” He observes that the Commission sometimes “contradict[s] the position taken in an earlier speaking order,” and that “the record is replete with instances” in which the Commission has “tak[en] different positions with regard to both the facts and the law in later, adjudicated proceedings.”

But the Commission’s prejudgment is evident when a speaking order contains findings of fact and conclusions of law concerning the conduct of others than the settling respondent and the Commission’s press release announces the order as a victory against wrongdoing. With respect to bias, all speaking orders contain boilerplate that unambiguously favors the Division to the detriment of nonsettling respondents.

That the Commission may sometimes take a position different from that taken in an earlier speaking order is little comfort to a nonsettling respondent who has been found guilty before trial in a public statement issued in the name of the persons who will hear and decide his case. We also note that every time the Commission contradicts the position taken in an earlier speaking order after review of an evidentiary record and consideration of opposing briefs, it demonstrates anew that speaking orders do not in fact provide a useful form of guidance.

Division of Enforcement personnel, though well motivated and honest in their allegations, are surely not infallible. And it must also appreciate that respondents will often settle cases—and make concessions for that purpose—for reasons having little or nothing to do with the merits of the Division’s claims against them or others. The Commission’s current process fails to take these factors into account and, in the balance, harms the quality and reliability of its adjudicatory process and orders. *

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1. The CEA does not require any findings to enter consensual sanctions. See, e.g., *In re Wright et al.*, CFTC Docket No. 97-2 (June 20, 2003).
2. CFTC release regarding Appendix A to the Investigative Rules, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,620 at p. 33,605 n.1, citing the SEC’s Wells submission release.
3. See, e.g., CFTC, *Statutory Interpretation Concerning Forward Transactions*, 55 Fed. Reg. 39,188 at p. 39,190, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,925 at p. 37,367 (1990); CFTC, *Policy Statement Concerning Swap Transactions*, 54 Fed. Reg. 30,694 at 30,694, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,294 at p. 36,143 n.4 (1989); CFTC, *Statutory Interpretation Concerning Certain Hybrid Instruments*, 54 Fed. Reg. 1139, 1 Comm. Fut. L. Rep. (CCH) ¶ 12,826 (1989), *reissued and corrected*, 55 Fed. Reg. 13,582 at n.23, 1 Comm. Fut. L. Rep. (CCH) ¶ 12,826A at p. 12,599 n.23 (1990); CFTC, *Regulation of Leverage Transactions as Contracts for Future Delivery or Otherwise*, 44 Fed. Reg. 13,494 at p. 13,496, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,772 at p. 23,161 (1979).
4. *In re BT Securities Corporation*, 52 S.E.C. 109 (Dec. 22, 1994).
5. See *Cary Oil Co. v. MG Refining & Marketing, Inc.*, 230 F. Supp 2d 439, 469 (S.D.N.Y. 2002).
6. For example, the settlement order entitled *In re Dynegy Marketing & Trade*, CFTC Docket No. 03-03, announced what some in the commodity bar viewed as a novel interpretation of Commission Regulations 1.35 and 140, by indicating that nonclearing members of a contract market must retain all records with respect to any cash market transaction that theoretically might affect or tend to affect the market price of a commodity, even if the cash commodity transactions are not related to any futures transactions of the contract market member.
7. See *Upton v. SEC*, 75 F.3d 92, 98 (2d Cir. 1996); *In re Cenco Inc. Securities Litigation*, 529 F. Supp. 411, 415-16 (N.D. Ill. 1982) (and cases cited therein).

8. *In the Matter of Shipley*, 45 S.E.C. 589, 591-92 n.6 (1974) (Shipley). In *Shipley*, 45 S.E.C. at 592 n.6, the SEC explained that its opinions issued in connection with settlements were written only after deliberation and analysis akin to that reflected in our opinions in contested cases. Hence they are as authoritative as opinions in those cases.
9. *Steadman v. SEC*, 46 S.E.C. 896, 917 n.66 (1977), *aff’d in part, rev’d in part*, 603 F.2d 1126, 1136 n.15 (5th Cir. 1979), *aff’d*, 450 U.S. 91 (1981).
10. *In re Walter*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,215 at 35,012 (CFTC 1988).
11. These factors have spawned the often-heard derisive reference among the defense bar to the “Alice in Wonderland” findings of speaking orders.
12. See G. F. Aronow, *Distinctions with Some Differences: CFTC and SEC Enforcement*, 21 FUTURES & DERIVATIVES L. REPT. 15, 18-19 (Oct. 2001), referring to circumstances in which there are limited or even skewed incentives on the part of respondents to debate the language of the proposed settlement order. Compare *In re Kolar*, 1999 SEC LEXIS 2300, *84-*85 (ALJ, 1999) (An “individual’s interest in contesting the wording of [a] report of investigation [drafted by the Division of Enforcement] was somewhat less than that of a respondent facing sanctions yet eager to remain in the industry”).
13. See 1 DAVIS AND PIERCE ON ADMINISTRATIVE LAW §1.4 at 13 (3d ed. 1994).
14. E.g., *In re Grain Land Cooperative*, [Current Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,636 (CFTC Nov. 25, 2003) (dismissing claims that the hedge-to-arrive contracts at issue were illegal, off exchange futures); *In re Abrams*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,479 (CFTC July 31, 1995) (dismissing manipulation charges); *In re Richardson Securities, Inc.*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,145 (CFTC 1981) (dismissing charges of aiding and abetting). In *In re Global Minerals & Metals Corp.*, CFTC Docket No. 99-11 (CFTC Order of Dismissal June 22, 2004), the Commission recently abandoned and dismissed a long-standing copper manipulation case without adjudication, observing that a “healthy skepticism is an appropriate response to even good faith estimates of the likelihood of success on the merits in manipulation litigation.” The Commission had earlier issued speaking orders in settling numerous manipulation cases, including a speaking order implementing a settlement in the very same proceeding. *In re Global Minerals & Metals Corp.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,686 (CFTC June 30, 1999).
15. See, e.g., *Withrow v Larkin*, 421 U.S.
16. See *Withrow*, 421 U.S. at 54 (The courts must “be alert to the possibilities of bias that may lurk in the way particular procedures actually work in practice.”).
17. See, e.g., *In re Prudential Securities, Inc.*, [2002-2003 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,180 (CFTC Oct. 9, 2002); *In re Avista Energy, Inc.*, [2001-2002 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,623 (CFTC Aug. 21, 2001).
18. *Withrow*, 421 U.S. at 47.
19. *McCarthy v. Madigan*, 53 U.S. 140, 148 (1992) (emphasis added).
20. *In re Murchison*, 349 U.S. 133, 13 (1955), quoted in *Withrow*, 421 U.S. at 47.
21. *Association of National Advertisers, Inc. v. FTC*, 627 F.2d 1151,

1158 (D.C. Cir. 1979), *cert. denied*, 447 U.S. 921 (1980), quoting *Cinderella Career & Finishing Schools, Inc. v. FTC*, 425 F.2d 583, 591 (D.C. Cir. 1970). *See also* *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 469 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959). This standard guarantees that the adjudicative hearing of a person facing administrative prosecution for past behavior is before a decision maker who has not prejudged facts concerning the events under review.

Association of National Advertisers, 627 F.2d at 1158.

22. *See Association of National Advertisers, Inc.*, 627 F.2d at 1158; *Cinderella Career & Finishing Schools, Inc.*, 425 F.2d at 591.

23. *Association of National Advertisers, Inc.*, 627 F.2d at 1155.

24. Commission Rule 10.108(b)(5), 17 C.F.R. § 108(b)(5), requires that a respondent's offer of settlement must "[c]onsent to the entry of an order reflecting the terms of settlement agreed upon." Rule 10.108(c), 17 C.F.R. § 10.108(c), provides that "offers of settlement made by a respondent shall be submitted in writing to the Division of Enforcement, which shall present them to the Commission with the *Division's recommendation*." (Emphasis added.)

25. Under Commission Rule 10.108(b)(3)(iv), 17 C.F.R. § 108(b)(3)(iv), an offer of settlement must "[i]nclude a waiver of ... [a]ny objection to the staff's participation in the Commission's consideration of the offer."

26. The Commission's prejudgment is further exacerbated by the fact that a speaking order is often if not usually accompanied by a press release that trumpets the sanctions imposed and commends the Commission's enforcement program for the result achieved. This publicly commits the Commission's institutional reputation and prestige to a particular view of the facts and a particular outcome, from which the Commission cannot subsequently withdraw without controversy and embarrassment.

27. Final Report at 55-60 (emphasis added); *see generally* Attorney General Manual on the Administrative Procedure Act 50-58 (1947).

28. H.R. REP. NO. 1980, 79th Cong., 2d Sess. 30-31 (1946) (emphasis added). *Accord* S. REP. NO. 752, 79th Cong., 1st Sess. 17-18 (1945).

29. 50 S.E.C. at 475 (emphasis added).

30. *Stuart-James*, 50 S.E.C. at 473. The SEC order challenged in *Stuart-James* avoided the prejudgment issue because it "simply dismissed the proceedings against [the settling respondent]. *No findings were made*." *Stuart-James*, 50 S.E.C. at 471 n.12 (emphasis added). The possibility of prejudgment resulting from a settlement with one of several respondents had earlier been discussed by the SEC in *In re Matters of Sinclair et al*, 44 S.E.C. 523 (1971), *aff'd sub nom. Sinclair v. SEC*, 444 F.2d 399 (2d Cir. 1971). But in that case, too, "*no findings [were] made*." *Stuart-James*, 50 S.E.C. at 472 (emphasis added).

31. The Commission has opined that due process and separation-of-functions considerations do not necessarily prevent enforcement personnel from presenting their view of the merits to the Commission subsequent to the commencement of the proceeding. *See In re Grain Land Cooperative*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,144 at pp. 45,376-78 (CFTC 1997). *But cf. In re Yeh*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,367 at 42,708, n.9 (CFTC 1995) ("The Division . . . may not advise the Commission about its decision in the adjudicatory aspects of the matter in issue."); *In re The Stuart-James Co., Inc.*, 50 S.E.C. 468, 475 (1991) ("Discussions between [the SEC] and the staff litigating a multi-party proceeding should be carefully circumscribed, so as to prohibit improper advice or influence with respect to a decision in the case against non-settling respondents").



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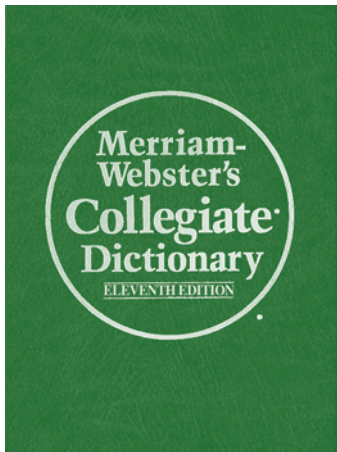
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OPINION

Keep Speaking, CFTC: In Defense of Speaking Orders A Response to Mills and Nathan

By Geoffrey F. Aronow

“The true genius shudders at incompleteness—and usually prefers silence to saying something which is not everything it should be.” Edgar Allan Poe

In their article, “CFTC Speaking Orders: Are They Lawful?” Charlie Mills and Dick Nathan argue that so-called “speaking orders” that the Commodity Futures Trading Commission (CFTC) issues are both legally improper and wrong-headed as a matter of policy. While their arguments are often elegant, they ultimately fall short on both fronts. They are based on mistaken premises with regard to both the law and the processes.

First, full disclosure. While the use of speaking orders began shortly before I became Director of the CFTC’s Division of Enforcement in 1995, it is fair to say that I embraced them, used them, and defended them enthusiastically. While I certainly believed I had an obligation to do so as a result of the position I held, I continue to believe that they do much more good than harm, not only for the Commission but, contrary to the perspective of Mills and Nathan, for the regulated community as well. I also believe that, while they are certainly subject to potential misuse, the law permits the Commission to issue them.

Like most manifestations of governmental authority and power, speaking orders certainly can be abused. Because they are the result of a nonadversarial process, the agency and its staff admittedly need to consider carefully what is said in these orders and how they are used. Indeed, as I have argued elsewhere,¹ there are unusual distortions in the process that produces settlement orders that warrant care: the context in which settlement orders are negotiated means that the respondents have little or no reason to concern themselves with certain aspects of the order, and every incentive to push for the most innocuous description of their conduct, which can lead to apparent distortions of the relationship between violations and sanctions. But equivalent risks are found in many aspects of the exercise of discretionary power by administrative agencies. This exercise of that power presents no greater risk than others.

Mills and Nathan begin by arguing that speaking orders are both too narrow and too serendipitous, and should be replaced by broad-ranging interpretive releases. But these characteristics of speaking orders are really their strengths, not their weaknesses. Unlike an interpretive release, a settlement order does not reflect an effort to provide comprehensive guidance, to identify and address all the contingencies that can arise with regard to some inter-

pretive issue. Rather, a settlement order simply reports the Commission’s thinking at a particular point in time with regard to a particular set of facts. In accepting a settlement, the Commission necessarily must decide what is a violation and what is an appropriate sanction. All the speaking order does is inform the reader of the reasoning that lies behind that particular decision.

The authors also assert that the negotiation of speaking orders is “a needless drain on the Commission’s limited enforcement resources.” But the agency is in the best position to determine whether the value of speaking orders is worth the cost in time and effort. If the agency thought otherwise, there is certainly nothing to prevent it from returning to the old methodology that Mills and Nathan advocate, “simple findings and conclusions.”

The question of what is meant by “simple findings and conclusions,” as contrasted with what is labeled “speaking orders,” moreover lies at the heart of the disagreement here. For the old form of orders that Mills and Nathan would like to see return was virtually opaque. Those orders told the reader virtually nothing about how the Commission got from the facts, which were set forth in bare-bones fashion or not at all, to the conclusion that a violation had occurred and that a sanction of the type imposed was appropriate.² The regulated community was left to try to divine from these scratchings on the wall what the Commission was thinking. “Speaking orders” are nothing more than an effort to connect-the-dots, to add the missing links so that those potentially affected by CFTC know what the agency is thinking. A speaking order lays out what got the Commission from point A to point B, rather than leaving the reader to guess. It tells the world what interpretation and application of the law to the facts in the particular case led the Commission to believe that it was making an appropriate finding and imposing an appropriate sanction in the context of a settlement.

Understanding that relationship between the “old” form of orders and the “speaking order” suggests a different conclusion as to their value and efficacy than Mills and Nathan reach. It is hard to see how the potential targets of CFTC enforcement scrutiny and actions, that presumably are trying to avoid getting in the Commission’s crosshairs, are better served by the old form of order, requiring Delphic oracles to interpret. It should not be only insiders who know what is going on. The speaking order gives the regulated community a fighting chance by offering, for better or worse, a clear exposition of the Commission’s rea-

soning lying behind the enforcement action reflected in the settlement.

The value of the speaking order is, indeed, much greater at the CFTC than at the Securities and Exchange Commission (SEC), where, as Mills and Nathan note, the practice originates and indeed where it has been used much more extensively and for a much longer period of time.³ There is greater value to be had from the CFTC's use of the speaking order because of the sparseness of adjudicated CFTC enforcement actions. Between the agency's modest docket, the percentage of settlements, and the limited number of matters that wend their way to an actual decision by the Commission itself, the body of adjudicated precedent at the CFTC leaves the regulated community with extremely limited guidance on many interpretive questions. Indeed, it is not unusual for a search for guidance on a particular issue to produce no relevant adjudicated cases, or at most one or two, often aged, precedent of only marginal relevance. While, as is discussed more thoroughly below, settlement orders are decidedly not precedent in the way that adjudicated decisions are, they at least provide a greater chance that those trying to understand the CFTC's thinking can find some insight into the way the Commission has approached a similar issue or a similar set of facts in the past.

In contrast, the SEC has a more extensive docket extending back over many more years, and hence much more useful adjudicated precedent.⁴ In those circumstances, there is a better case to be made that the hazards associated with speaking orders could outweigh their value. But in light of the CFTC's sparse administrative precedent, the insights provided by speaking orders make an important contribution to the understanding of the Commission's perspective on issues.

Speaking orders are said to cause "consternation" especially when they are used to "announce ... a novel legal position." The example Mills and Nathan offer is a recent settlement order that indicated that a sanction was being imposed in part for the failure of a nonclearing contract market member to retain records of cash commodity transactions that were unrelated to any futures transactions of the contract market member.⁵ Using that example, let us look at the situation the regulated entities would find themselves in if this case had been settled without a speaking order, and consider whether they would be better off.

By issuing a speaking order, the Commission has told the world that it is applying this interpretation of the law through its enforcement program. Contract market members therefore know that there may be investigations based upon that theory, and they may face the possibility of enforcement actions based upon the failure to meet that standard. This is valuable knowledge, since most targets of CFTC enforcement actions settle rather than fight, for a variety of reasons that only partially includes their evaluation of the potential for success on the merits. Moreover, knowing the analysis that was behind that settlement allows participants and their counsel to raise a ruckus, complain about how this theory overreaches—even, if they wish, seek to trigger the very interpretive release process that Mills and Nathan embrace, in an effort to get the Commission to evaluate this issue anew.

The alternative advocated by Mills and Nathan would have the Commission recite a limited number of facts, and then simply recite the violations, presumably including a recitation of violations of the rules in question. The Commission would leave out the interpretive gloss on the rules that led the Commission to conclude that there were violations. The regulated entities and their attorneys would be left to scratch their heads and try to figure out from the limited, recited facts why the Commission thought there were violations of the rules.

To illustrate, let us go now to the Law Offices of Geoffrey Aronow (a person purely of my invention), where Mr. Aronow is perusing this latest "simple" settlement order issued by the CFTC. We see Mr. Aronow sitting at his desk, a puzzled look on his face. He is muttering out loud to himself: "Let's see now. The Commission found record-keeping violations, but I wonder why. Were there some missing records related to futures trading? I do not really see that in the facts. Were there records of cash market transactions related to futures trading that the CFTC could not get? I cannot really see that in these facts either. Wait—could it be that the CFTC thinks contract market members have to keep records of cash market transactions unrelated to futures trading? That does not seem possible. I certainly cannot start advising all my clients that they had better keep those records if they want to avoid trouble with the CFTC just because that *may* be what this settlement suggests the Commission is thinking. Gosh, I do not know what to make of this settlement." I cannot see how the fictitious Mr. Aronow, his clients or any of the rest of us would be better off with this scenario in contrast to being told what lay behind the Commission's action.⁶

Indeed, in the opaque world of nonspeaking orders, the picture is likely to be even murkier than the scenario set forth above suggests. It is quite possible that the reader could be misled by a limited or no recitation of facts and a finding of violations into making the *wrong* analytical connections. It is quite possible, to use the same example, that the reader would presume that the violations were based upon missing records related to futures trading, or cash market trading related to futures positions, and thus the reader would blithely assume that the Commission had imposed sanctions simply by application of a well-established view of the rule. She would not even stop to think that the Commission was acting on the basis of a new, more controversial interpretation of the rule, and so she would not even think about whether to warn her clients about this new peril. The only ones who might know the truth would be the respondent and its attorneys. Again, it is very hard to see how that is a better or fairer state of affairs for anyone.

All a speaking order does is inform the reader of the reasoning that lies behind a particular decision.

Mills and Nathan are rightly concerned about efforts by the courts and agencies to treat speaking orders as precedent. To the degree the SEC has suggested it would do so,⁷ it is treading on dangerous ground. But the idea that speaking orders can be treated as precedent that is equivalent to adjudicated cases is not even universally embraced within the walls of the SEC. See, e.g., *In the Matter of F.X.C. Investors Corp. et al.*, 2002 WL 31741561 at *9 (S.E.C. Release No. 218, ALJ Dec. 9, 2002) (“The Division’s reliance on settlement orders is misplaced. . . . Settlements involving so-called ‘speaking orders’ are particularly suspect.”); *In the Matter of Dean Witter Reynolds Inc. et al.*, 2001 WL 47244 at *49 n. 106 (S.E.C. Release No. 522, ALJ Jan. 22, 2001) (rejecting the staff’s reliance on two settled cases, at least one of which was announced in a speaking order, because “[s]ettled cases are of little, if any, precedential value”). More important, in this context,

as Mills and Nathan acknowledge, it is decidedly not the view that the CFTC has adopted. The Commission got it right when it wrote, “settlements are not precedential in the ordinary sense, [although] they are some indication of the Commission’s approach.”⁸

The heart of Mills’s and Nathan’s concerns seems to lie with the impact of speaking orders in multiparty cases. Those situations certainly do raise the greatest concerns with regard to fairness, concerns to which the Commission and the staff must remain extremely sensitive as they go about their work. But before addressing the legal con-

cerns, the prudential concerns expressed in this regard trigger two observations that essentially echo the discussion above, but applied to this particular context. First, Mills and Nathan themselves note a number of instances in which the Commission has taken a position in an adjudicatory proceeding that contradicted the position taken in an earlier speaking order. There can be no better evidence that the Commission takes seriously its commitments not to treat speaking orders as precedent, not to treat other parties as bound by any of the findings in speaking orders, nor to prejudge the case based upon the findings made in the speaking order. Second, unless you are going to prohibit the agency from separately settling related cases or charges against different respondents, then there is no way to avoid having the Commission consider whether it believes the facts and the law support the proposed settlement. That inevitably draws the Commission into a process of looking at the facts, looking at the law, and making judgments. If that is inevitably going to happen, the remaining respondents are better off seeing the reasoning that lies behind those judgments laid out before them in a speaking order,

rather than having that reasoning hidden from them behind an opaque “simple” settlement order.

The legal arguments against the practice of settling with some defendants in related cases rest mainly on extrapolation from general legal principles with which few would argue. For instance, Mills and Nathan assert that speaking orders violate constitutional and statutory rights of nonsettling parties to a fair adjudication when the orders contain “definitive findings” that “impact” on the nonsettling parties’ case, without citing any law to support that claim.

The fact is that there is no evidence of actual “prejudgment.” As it states quite specifically in each settlement order, the Commission makes findings solely for the purposes of the case before it. If respondents find evidence that those previous findings prevent fair adjudication of their later-adjudicated case, they can raise an objection, although the legal standard for demonstrating prejudice is appropriately high.⁹ Moreover, as Mills and Nathan themselves point out, the record is replete with instances of the Commission taking different positions with regard to both the facts and the law in later, adjudicated proceedings. So, contrary to the authors’ suggestion, as a matter of form and as a matter of reality, there is not evidence of prejudgment or bias.

Mills and Nathan also express some concern about the restrictions placed upon a settling party with regard to denying publicly the findings of fact in the settlement order. Whatever the merits of this concern, it really is not an issue that arises because the Commission uses a speaking order. Even the “simple” orders that the authors advocate would contain some factual findings, albeit perhaps conclusory, and the same violations. The Commission would still insist that a settling party not turn around and deny the facts and the violations in the same breadth that he or she is agreeing to “neither admit nor deny” them, which is a standard requirement for settling with the SEC, the CFTC and other federal regulatory agencies.¹⁰

Putting aside the question of the relevancy of this concern to a discussion of speaking orders, while the authors agree that the agency has some right to require the settling party not to deny wrongdoing or dispute the findings to which he or she has consented, they say that the Commission should not be able to “broadly restrict free speech and communication regarding matters that remain in dispute,” thus disadvantaging nonsettling respondents. But the standard settlement order language simply restricts “actions and public statements” that effectively deny the findings. And, as Mills and Nathan note, the standard language expressly exempts all “testimonial obligations” from the restriction.¹¹ So, it does not follow that these provisions restrict the ability of nonsettling respondents to put on their defense. While the authors point to their experience dealing with “a not unreasonable fear of retribution and possible sanctions if the settling respondent should cooperate with nonsettling respondents,” they do not point to any instance where the Enforcement Division has made such a threat in the face of such cooperation, let alone to any evidence that the Commission or the courts would support an effort to prevent such cooperation.

Remaining respondents can see the reasoning behind the Commission’s judgments in a speaking order.

In a similar vein, Mills and Nathan concede that it is okay for the CFTC to extract a promise to “cooperate” with the agency, but they say that the phrasing of the promise “interferes” with the ability of the respondent to cooperate with anyone else. They do not cite particular language creating their concern. While the cooperation provisions of the settlement orders often denominate the ways in which the settling respondent agrees to cooperate with the CFTC, no language restricts the ability of the settling party “to cooperate with anyone else.”¹² The authors do not cite any instance where the Commission has tried to assert otherwise.

While the authors cite the established general precedent regarding bias and prejudice,¹³ they cite no cases that suggest the process of issuing settlement orders of the type about which they are complaining create improper prejudice or bias—this, despite the fact that the SEC has been issuing them for many years.¹⁴

This lack of direct precedent undoubtedly results from the fact that the test for establishing bias is not as easy as Mills and Nathan would make it sound. As the D.C. Circuit has stated:

In each new case the judge confronts a new factual context, new evidence, and new efforts at persuasion. As long as the judge is capable of refining his views in the process of this intellectual confrontation, and maintaining a completely open mind to decide the facts and apply the applicable law to the facts, personal views on law and policy do not disqualify him from hearing the case. The test may be stated in terms of whether the judge’s mind is “irrevocably closed” on the issues as they arise in the context of the specific case.¹⁵

In the situations involving partial settlements in multirespondent cases, the Commission specifically states in its speaking order the limited purpose and reach of the findings it has made. Barring evidence that it is unable to make the separation that it undertakes—and Mills and Nathan suggest that the evidence supports the fact that the Commission can and does make that separation—then there seems to be little basis to claim that the Commissioners’ minds are “irrevocably closed on the issues as they arise in the context of the specific case.”

Mills and Nathan also base their argument for the legal impropriety of the speaking order on the legal prohibitions on ex parte communications. But, again, their argument proves too much. Unless we are prepared to prohibit all settlements with only some respondents in a multirespondent case, then the types of communications about which Mills and Nathan worry will necessarily take place, whether or not the arguments in favor of the findings of violation are laid out for the public to see in a speaking order. The staff must explain to the Commission why the settlement is appropriate. They can do that only by explaining why the law and facts support a finding of a violation and why the particular sanctions are appropriate. Thus, the choice is between having that analysis laid out in

the open for everyone to see, or to have it hidden behind an opaque “simple” settlement order.

As for the law, Nathan and Mills cite only a case from the SEC, in which the Commission properly advised that because of the “danger of abuse” in multiparty cases, discussions with staff “should be carefully circumscribed,” so that “improper advice or influence” with regard to “a decision” in the case against nonsettling respondents is not communicated.¹⁶ All that is undoubtedly true, and would apply to the CFTC deliberative process as well—the discussion of the settlement should not include “advice or participation in decision making” as to the nonsettling parties. But the process of explaining to the Commission why a settlement should be accepted does not require “advice or participation in decision making” as to the nonsettling parties, nor is there anything about speaking orders that creates the necessity to violate that stricture. This is not to say abuse cannot occur, but abuse does not appear to become inherently part of the process simply by reason of the fact that the Commission chooses to set forth in its order the rationale behind the settlement.

Indeed, this argument against speaking orders is really another way of questioning the Commission’s ability to put aside its reasoning in accepting a settlement when it is later called upon to decide the facts and law in a subsequently contested proceeding involving a nonsettling defendant. Again, there does not seem to have been any difficulty in it doing so in reality, nor should it be any more legally suspect than when a court must rehear a case on remand because of a mistake in the original trial of the matter. In any case, whatever problem exists is inherent to the process of deciding whether to accept a partial settlement in a multiparty case, and is not created by issuing speaking orders.

In sum, Mills’s and Nathan’s attack on speaking orders is not ultimately supported by the law and, as a matter of policy, advocates a position that is not really beneficial to the regulated community. Speaking orders throw light on a process that would otherwise be hidden away from view. They allow the world to see what lies behind Commission action in the exercise of its most awesome responsibility, the sanctioning of market participants. They allow persons other than insiders to understand what is motivating the Commission in its enforcement program and to weigh risks before it is too late. In a context in which most participants will ultimately settle rather than risk litigating against the Commission, this is critical information. And they allow those subject to the Commission’s enforcement authority and their counsel to raise a stink before it is too late if they think the Commission is pursuing an enforcement agenda based

Speaking orders allow persons to understand the motivation behind the Commission in its enforcement program.

on a mistaken view of the law. The opportunity to raise those concerns would not exist without speaking orders.

There are undoubtedly tensions and risks that arise as well from the process of issuing speaking orders. Much of administrative law represents the effort to balance the risks and tensions inherent in the administrative processes that this nation embraced wholeheartedly in the twentieth century, processes that meld together elements of legislative and executive authority, elements of prosecutor and judge, and elements of policy making and enforcement.¹⁷ Speaking orders reflect risks and tensions no greater than those inherent in such a system, and provide many benefits, particularly with an agency like the CFTC that has few adjudicated precedents to which people can look for guidance and where most litigants settle. There certainly do not seem to be greater constitutional issues in using speaking orders than those issues inherent in such a system of administrative law.

In the end, therefore, I believe a dispassionate look at the facts and the law, as Mills and Nathan ask the CFTC to take, shows that the alarm they sound is unnecessary. After a decade of their use, it is time to embrace CFTC speaking orders and to acknowledge their real value, not argue for their abolition. *

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1. See G.F. Aronow, *Distinctions with Some Differences: CFTC and SEC Enforcement*, 21 FUTURES & DERIVATIVES L. REPT. 15 (Oct. 2001).

2. See, e.g., *In The Matter Of First Commodity Corp. Of Boston et al.*, 1989 WL 242086 (CFTC July 26, 1989).

3. A quick Westlaw search revealed SEC orders fitting the Mills and Nathan definition of a “speaking order” going back to the late 1950s and early 1960s. See, e.g., *In the Matter of Carl M. Loeb, Rhoades & Co. et al.*, 38 S.E.C. 843 (Feb. 9, 1959); *In the Matter of Reynolds & Co. et al.*, 1960 WL 7757 (SEC Release Nos. 8-219, 8-3818, 8-4865, May 25, 1960). They may well date back further.

4. The SEC, of course, was formed in the mid-1930s while the CFTC dates only from the mid-1970s. In its fiscal year 2003 Annual Report, the SEC stated that it had brought 365 administrative proceedings during fiscal year 2003 and 281 administrative proceedings in fiscal year 2002. SEC Annual Report (FY 2003) at 17 (found at <http://www.sec.gov/pdf/annrep03/ar03full.pdf>). The comparative figures for the CFTC were 33 and 18, respectively. See CFTC FY 2003 Annual Report at 49 (found at <http://www.cftc.gov/files/anr/anr2003ar.pdf>).

5. *In re Dynegy Marketing & Trade*, CFTC Docket No. 03-03 (CFTC Dec. 18, 2002).

6. Mills and Nathan also assert that the process that produces speaking orders is wholly without any checks and balances. While it is not an adversary process, there are internal procedures by which the reasoning behind the orders is vetted, including with

the CFTC’s Office of General Counsel. Overall, it is hard as an outsider, even as an outsider once on the inside, to evaluate the comparative degree of scrutiny given settlement orders as against opinions in adjudicated cases. And the fact that the CFTC has departed in later adjudicated proceedings from positions taken in settlement orders—a fact that Mills and Nathan point to as evidence of the unreliability of the process that produces speaking orders—may reflect nothing more than the changing views of the Commission, or the differing factual context in which issues arise. Indeed, as discussed further below, the fact that the Commission has changed its position in adjudicated proceedings mainly belies Mills’s and Nathan’s concern about the prejudgment effects of speaking orders.

7. See *In the Matter of Shipley*, 45 S.E.C. 589, 591-92 n.6 (1974).

8. *In re Walter*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,215 at 35,012 (CFTC 1988).

9. See text and endnote at *infra*, note 17.

10. See, e.g., *In the Matter of Cummings et al.*, S.E.C. Release No. 34-50544 (Oct. 14, 2004) (settlement order; respondents consent to entry of the order “without admitting or denying the findings herein”); “Providian to Cease Unfair Practices, Pay Consumers Minimum of \$300 Million Under Settlement with OCC and San Francisco District Attorney,” NR 2000-49 (June 28, 2000) (announcing settlement order by the Office of the Comptroller of the Currency; “In entering into the consent order, the bank did not admit or deny wrongdoing.”).

11. See, e.g., *In the Matter of Coral Energy Resources, LP*, CFTC Docket No. 04-21, slip op. at 7 (CFTC July 28, 2004).

12. See, e.g., *id.* at 6-7.

13. See *Assoc. of Nat’l Advertisers, Inc. v. FTC*, 627 F.2d 1151 (D.C. Cir. 1979), *cert. denied*, 447 U.S. 921 (1980); *Cinderella Career & Finishing School, Inc. v. FTC*, 425 F.2d 583 ((D.C. Cir. 1970).

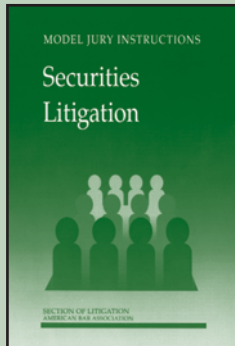
14. Indeed, the SEC settlement order from 1960 cited earlier, see *In the Matter of Reynolds & Co.*, *supra* n.3, involved a settlement with some respondents in a multirespondent situation, and includes language, similar to what is included in such settlement orders today, in which the SEC stated that the findings would not be binding with regard to any person other than the settling respondents.

15. *Southern Pacific Communications Co. v. American Tel.*, 740 F.2d 980, 991 (D.C.Cir. 1984).

16. *In re The Stuart-James Co., Inc.*, 50 S.E.C. 468, 473 (1991).

17. “The tension inherent in administrative law between the need for expertise and the ‘introduction of unacceptable levels of bias’ into the adjudicatory process has existed for centuries, and is not likely to end soon.” [Harold H. Bruff, *Specialized Courts in Administrative Law*, 43 ADMIN. L. REV. 329 (1991)] at 334 (addressing the need for balance within the administrative adjudicatory process). See also Frank E. Cooper, *Administrative Agencies and the Courts* (1982), at 21 (noting that the fundamental differences between administrative and judicial procedures are due to the fact that agencies are normally parties in interest to the proceedings). Heather Rutland, *Civil Rights Are Civil Rights: The Inapplicability of Preclusion to Unreviewed State Administrative Decisions*, 20 NAT’L ASS’N ADMIN. L. JUDGES 199, 202 n.10 (Fall 2000).

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