



corporate
law

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HOLDING COMPANIES CRIMINALLY RESPONSIBLE

Decision to go after corporate entities boils down to three basic prosecutorial theories

By **ANDREW P. GAILLARD**

Enron, WorldCom, Hewlett-Packard, Arthur Andersen. These are some of the most recognized corporate names over the past five years, not because of any great business successes, but because of scandals and criminal prosecutions.

An informal survey of cases in Connecticut identifies fewer than a dozen companies prosecuted criminally by the U.S. Attorney's office in 2006, though many more were investigated. The charged conduct of the Connecticut corporate prosecutions runs the gamut of "white-collar" offenses, including environmental, tax, Medicare, government contracting, and bribery offenses, plus an unusual case involving the illegal importation of chicken feet from Thailand.

Because it is not intuitive how a corporate entity can have the *mens rea* that law school taught us was a prerequisite to criminal culpability, and because the collateral consequences to employees, shareholders and other third parties can be devastating when a company is charged criminally, it is worth considering what makes a company guilty of a crime.

There is a notable lack of consistency across state—and even federal—jurisdictions, but three basic prosecutorial theories exist for holding companies criminally responsible: (1) *respondeat superior*; (2) strict liability; and (3) the "collective knowledge" doctrine.

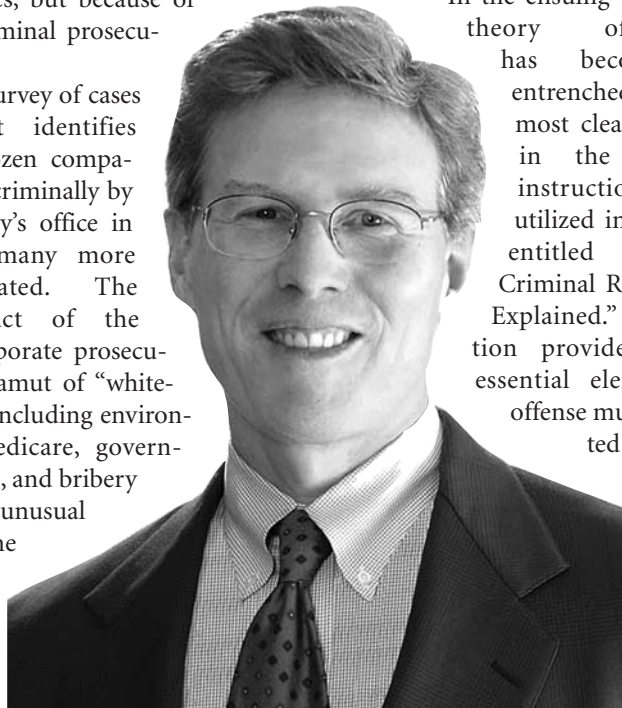
Respondeat Superior

The most common basis for corporate criminal liability, *respondeat superior*, was not widely accepted until 1909. In *New York Central & Hudson River Railroad Co. v. United States*, 212 U.S. 481 (1909), the U.S. Supreme Court rejected the railroad's argument that to "take the money of a corporation for crime committed by the individuals who control it, is to take the property of every stockholder. It amounts to punishing the innocent for the guilty."

Citing various precedent, the Supreme Court saw "no valid objection in law, and every reason in public policy, why the cor-

poration which profits by the transaction, and can only act through its agents and officers, shall be held punishable by fine because of the knowledge and intent of its agents to whom it has entrusted authority to act."

In the ensuing 100 years, this theory of liability has become firmly entrenched, and is now most clearly articulated in the form jury instruction commonly utilized in federal court entitled "Corporate Criminal Responsibility - Explained." The instruction provides that each essential element of the offense must be committed by an officer,



director, employee or agent of the company, that the acts committed "must be within

the scope of the employment or agency" of the actor, and that the individual acted with "the intent to benefit" the company. Today, most corporate prosecutions are premised on this theory.

Strict Liability

A slightly more recent—and increasingly used—theory of corporate criminal liability approaches strict liability.

In certain highly regulated industries, statutes often do not require bad intent as an element of an offense (although some degree of "knowledge" is generally required). Environmental crimes, FDA offenses and other similar "regulatory" cases impacting public health and welfare are the type to trump theoretical questions about a corporation's "guilty mind."

In a seminal case involving the interstate shipment of misbranded drugs, for example, the Supreme Court stated: "Such [public welfare] legislation dispenses with the conventional requirement for criminal conduct—awareness of some wrongdoing. In the interest of the larger good it puts the burden of acting at hazard upon a person otherwise innocent but standing in responsible relation to a public danger." *United States v. Dotterweich*, 320 U.S. 277, 281 (1943).

To the extent such statutes require any

particular mindset, typically all that is required is a "knowing" violation, and even the knowledge element may be watered down: "[W]here ... dangerous or deleterious devices or products or obnoxious waste materials are involved, the probability of regulation is so great that anyone who is aware that he is in possession of them or dealing with them must be presumed to be aware of the regulation." *United States v. International Minerals & Chemical Corp.*, 402 U.S. 558, 565 (1971).

'Collective Knowledge' Doctrine

The third, and far less common, theory supporting criminal prosecution of a corporate entity is the so-called "collective knowledge" doctrine. This theory holds that, even if no single employee of a corporation possesses the requisite scienter to support a conviction, a court or jury may aggregate the knowledge and intent of two or more employees to find the company criminally responsible.

The doctrine was most clearly addressed in *United States v. Bank of New England N.A.*, 821 F.2d 844 (1st Cir. 1987). The case involved a bank customer who repeatedly cashed checks and received in excess of \$10,000 from certain tellers. The tellers were not aware that federal law required such transactions to be reported to the Treasury Department, although more senior bank personnel did know of the requirement.

The following instruction on collective knowledge was upheld by the First Circuit: "[Y]ou have to look at the bank as an institution. As such, its knowledge is the sum of the knowledge of all of the employees. That is, the bank's knowledge is the totality of what all of the employees know within the scope of their employment."

The First Circuit approved the instruction in part on policy grounds by expressing a concern that absent such liability, companies might be encouraged to "compartmentalize" information so as to avoid liability. While the logic is debatable, the holding is clear that companies may be convicted even in circumstances where no individual employee could be.

Given our current climate of scandal, criminal investigations and prosecutions of corporations are likely to increase. As the Arthur Andersen prosecution clearly demonstrated, the consequences can be severe. It is thus critical to understand the legal theories supporting such prosecutions. ■

Environmental crimes, FDA offenses and other similar 'regulatory' cases impacting public health and welfare are the type to trump theoretical questions about a corporation's 'guilty mind.'

Andrew P. Gaillard is a partner in Day Pitney's Stamford office. As a member of the firm's White-Collar Defense and Internal Investigations Practice Group, he represents corporate and individual clients in all manner of civil and criminal cases.

NO Second Guessing

LEVERAGED SPIN-OFF GETS STAMP OF APPROVAL

By **CORINNE BALL**

In recent years, the use of spin-offs has become an increasingly important tool for companies to divest non-core or underperforming businesses. In addition to the attendant tax concerns, a spin-off may give rise to a host of issues relating to state law fiduciary duty and state and federal fraudulent transfer claims.

On March 30, the Third Circuit Court of Appeals addressed such claims in the context of Campbell Soup's "leveraged spin-off" of Vlastic, of pickle fame, and Swanson, the TV Dinner manufacturer. The case, *VFB LLC v. Campbell Soup Co.*, involved claims of the bankruptcy estate of the entity resulting from the spin-off, Vlastic

Foods International Inc., against Campbell for aiding and abetting a breach of fiduciary duty and for fraudulent transfer liability.

In affirming the district court's judgment for Campbell, the Third Circuit relied on the capital markets' appraisal of the spin-off as strong evidence of Vlastic Foods' value and, based on this evidence, agreed with the district court that the transfer was for reasonably equivalent value and did not render Vlastic Foods insolvent. Accordingly,

both the fiduciary duty and fraudulent transfer claims were rejected.

The Third Circuit's reliance on the capital markets as an objective valuation is a welcome development for those wishing to utilize spin-offs as a divestiture tool without fear of a court, years later, second guessing the transaction with the benefit of hindsight.

Many Advantages

The term "spin-off" generally refers to a company's divestiture of its subsidiary or division by transferring the shares of the subsidiary to the company's shareholders in the form of a dividend.

Spin-offs have become increasingly common as a restructuring tool because of

their many advantages: spin-offs can provide enhanced access to capital markets, can improve management incentives, and can facilitate effective cost monitoring by market forces. In addition, spin-offs can accomplish substantially the same goals as, and can have significant tax advantages over, a straightforward sale of the subsidiary either to the public in an initial public offering or to a single acquiror in a negotiated sale.

Beginning in 1996, ideas of spinning-off Vlastic, Swanson and other brands began to percolate among Campbell's management.

Vlastic and Swanson, though historically strong, were both troubled, and it was thought that they could be turned around under new management. Although a traditional sale process was initially considered, it was ultimately determined that a spin-off would be more advantageous because of practical problems associated with an outright sale.

On the one hand, selling the brands individually would be time consuming, divert management's attention, and depress Campbell's earning per share. On the other hand, selling the brands as a group would not be attractive to other food companies and would, therefore, limit the sale to financial buyers, resulting in a price discount. Accordingly, Campbell determined that divesting the brands through a spin-off was a quick, certain method, that would minimize senior management's time, result in value similar to a sale, and be potentially tax free.

On March 30, 1998, the deal closed. The type of spin-off settled upon was a "leveraged spin." This involved Campbell incorporating a wholly-owned subsidiary and borrowing \$500 million in bank debt pursuant to a loan agreement. The loan agreement provided that upon transfer of the spin-off companies, the subsidiary would assume the bank debt. The result was that Campbell received \$500 million, and the new company, Vlastic Foods, received the spin-off companies and assumed \$500 million in debt.

The deal seemingly worked well for Campbell: It was now able to refocus on its core businesses, the transaction resulted in tremendous tax savings, and Campbell was able to take a sizeable chunk of cash out of the spin-off. In the coming months, Vlastic Foods would not be as happy. Soon after the

Circuit's reliance on capital markets as objective valuation a welcomed development

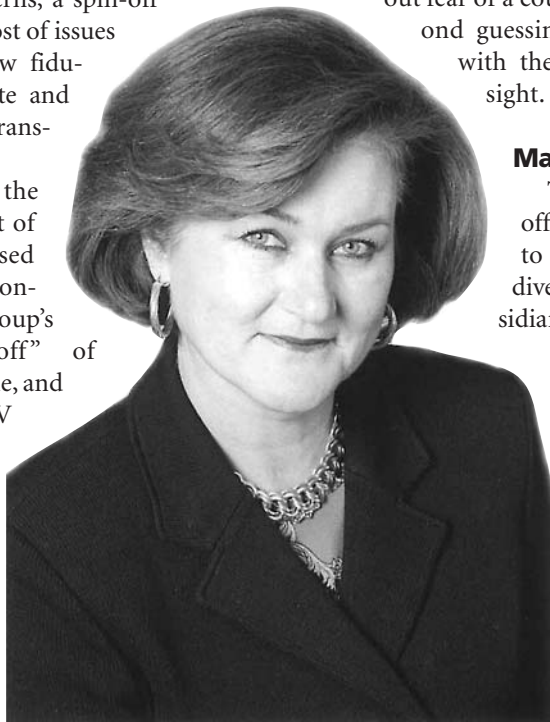
spin, it became apparent that Campbell had engaged in tactics that would inflate the company's short term sales with a corresponding decrease in later period sales. By June of 1998, Vlastic Foods lowered its FY 1998 earnings estimates from \$143 million to \$70 million and, in September 1998, renegotiated with the banks to avoid a covenant default.

The banks, in turn, demanded that Vlastic Foods issue \$200 million in contractually subordinated bonds. Vlastic Foods complied. Slowly, however, Vlastic Foods began to decline, and several years later, on Jan. 1, 2001 filed for chapter 11. VFB, the successor in interest to Vlastic Foods, brought claims against Campbell alleging that Campbell aided and abetted a breach of fiduciary duty in engaging in the spin and that the spin transaction was constructively fraudulent as to Vlastic Foods' creditors. After a bench trial, the district court found for Campbell and the Third Circuit affirmed.

Fraudulent Transfer?

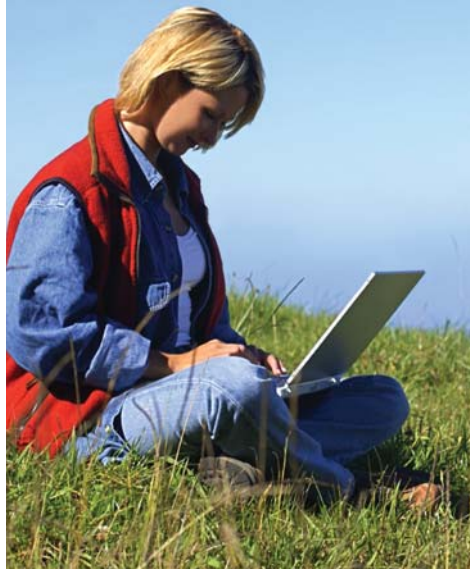
Both the Bankruptcy Code and state law provide causes of action to avoid and recover certain constructively fraudulent transfers. Under New Jersey's version of the Uniform Fraudulent Transfer Act, which applied in VFB, a transfer is considered constructively fraudulent as to an existing creditor of the debtor if the debtor was insolvent at the time of the transfer and if, in exchange for the transfer, the debtor did not receive reasonably equivalent value. The determination of whether the debtor received reasonably equivalent value is made as of the date of the transfer. How to value a company, especially several years later, is a contentious topic.

■ See **FRAUDULENT** on PAGE 8



Corinne Ball is a partner at Jones Day.

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Effective **DETERRENT****PRIVATE LITIGATION HELPS POLICE MARKETS**

Securities fraud class actions play important role in deterring corporate misconduct

By **JOEL SELIGMAN**
and **HARVEY GOLDSCHMID**

A recent commentary by Stanford Law Professor Joseph A. Grundfest in the *Wall Street Journal* provided fresh evidence of a broad backlash by some business and academic leaders against the Sarbanes-Oxley Act reforms, enhanced U.S. Securities and Exchange Commission (SEC) enforcement in the post-Enron era and the vital fraud deterrent and investor safety net provided by securities litigation.

Specifically, securities fraud class actions are under attack, with some, in effect, calling for their abolition, even though the number of such suits has declined from approximately 193 per year from 1996 to midyear 2005 to 90 from mid-2005 through 2006.

The decline in securities fraud litigation

Joel Seligman is president of the University of Rochester and has written several books about securities regulation. Harvey J. Goldschmid is Dwight Professor of Law at Columbia Law School and served as a commissioner of the SEC from 2002 to 2005, and it general counsel in 1998 and 1999.

Commentary

reflects a reduction in the incidence of securities fraud since the "Enron era." This is because of critically important changes that were made by the Sarbanes-Oxley Act and the SEC to business disclosure, corporate governance, the roles of gatekeepers (like accountants and lawyers) and enforcement. Nevertheless, given the dual threat to SEC enforcement created by flat budgets and the business

backlash, it would be a tragic error to eliminate private securities fraud class actions. They remain, in the SEC's traditional words, "a necessary supplement to the Commission's efforts." Quite simply, these suits provide the primary method for defrauded investors to recover their losses.

Go back about five years. This country was in the midst of the largest securities

fraud wave in its history. Daily news stories highlighted the alleged misconduct of major corporations, includ-

actions have played an important role in deterring corporate misconduct.

Is the system perfect today? Of course



Investors have little other recourse than private suits because the SEC's disgorgement and monetary penalty powers are limited.

ing Enron Corp. and WorldCom Inc. As significant were several other lesser known trends. Financial restatements had grown linearly between 1997, when there were 116

restatements, and 2001, when there were 305. Not all of the restatements should be attributed to fraud, but a significant number fairly could be. The staff of the SEC had not grown by a single position between 1995 and 1998. Deterrence, as we entered the new century, had been grievously weakened. Significant areas of concern, such as research analysts, were largely unaddressed by the commission. In the months running up to the enactment of the Sarbanes-Oxley Act, aggregate stock market values declined by more than \$7 trillion between selected dates in March 2000 and July 2002.

These developments led Congress (by a vote of 99-0 in the Senate and 423-3 in the House), the SEC, the New York Stock Exchange and the National Association of Securities Dealers to respond vigorously with the Sarbanes-Oxley Act and other important reforms. Conflicts of interest in the auditing profession and in corporate board practice have been systematically reduced. Internal auditing controls have been effectively strengthened through executive certification and the much-criticized § 404 of Sarbanes-Oxley. The SEC's budget was dramatically increased, and the SEC and Justice Department devoted much greater resources to enforcement. And private securities class

not. It is nearly universally recognized that compliance costs with respect to § 404 of Sarbanes-Oxley have been too high, particularly for small and medium-sized firms. But the system is working. The Public Company Accounting Oversight Board has recently proposed revising its most expensive Audit Standard No. 2 (the basis for most complaints about § 404) and replacing it with a streamlined Audit Standard No. 5. The SEC itself has offered constructive guidance that should further reduce compliance costs.

But to abruptly end the class action remedy to securities fraud, as some recommend, would be to throw out the baby with the bath water. These suits provide a vital deterrence and safety net.

Only yesterday, as historian Frederick Lewis Allen wrote in similar circumstances, the enforcement agencies seemed to be weakened to an extent that they could not effectively deter fraud. Given federal budgetary and political realities, these times can

easily return. Moreover,

even in a period of robust enforcement, the government relies upon private litigation to help police the markets and recover money otherwise lost to wrongdoing. Investors have little other recourse than private suits

because the SEC's disgorgement and monetary penalty powers are limited and will generally cover only a fraction of the damage done to investors by serious securities fraud.

The challenge of a wise system of securities regulation is neither to "overdeter" and chill legitimate corporate activity nor to "underdeter" and encourage corporate misbehavior. Two important ways to get the balance right is to reduce the wide pendulum swings in SEC budgets and to leave unhobbled the vital safety net provided by private litigation. ■

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Weakness EXPOSED**NO EASY WAY AROUND INSIDER-TRADING CHARGES**

‘Disclosure to the source’ defense put to the test

By **JEREMY FREEMAN**

The misappropriation theory of insider trading, which was first recognized by the Supreme Court in *United States v. O'Hagan*, 521 U.S. 642 (1997), establishes liability for individuals who are not typical “insiders” of companies and also appears to offer such defendants a specific defense to insider-trading charges.

The *O'Hagan* Court based the misappropriation theory on a duty owed by the defendant to the source of non-public material information, rather than to the shareholders of the company whose stock was being traded. Because a defendant prosecuted under the misappropriation theory had a duty only to his source, the court explained that a defendant's disclosure to the source of information prior to trading or tipping could neutralize the acts of deception necessary for a securities fraud claim.

This “disclosure to the source” defense remained untested until a recent SEC action against Patricia Rocklage, the wife of a pharmaceutical executive. Rocklage defended against the SEC's allegations of insider trading by arguing, in part, that she disclosed to the source of her informa-

tion—her husband—her intent to use the material non-public information she had obtained in confidence. *SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006).

The 1st Circuit, expressing uncertainty and reservations about the scope and application of the “disclosure to the source” defense, distinguished *O'Hagan* and found that *Rocklage* could be held liable for insider trading despite her disclosure. The

his corporation on the basis of material, non-public information. Liability under the classical theory is based upon the breach of a duty of trust that the insider owes the shareholders of the corporation.

The misappropriation theory was borne of the desire to extend the same liability to those who were not corporate insiders but nevertheless possessed material non-public information. So the Supreme Court

decision set limits on the classical theory of insider trading, *Chiarella v. United States*, 445 U.S. 222, 231-35 (1980). In *Chiarella*, the insider trading conviction of a financial printer responsible for preparing documents in a corporate takeover was reversed on the basis that the defendant owed no duty to the company or its shareholders and thus could not be prosecuted under the classical theory.

Seventeen years later, the Supreme Court in *O'Hagan* confronted another case where a non-insider, a lawyer, was criminally prosecuted for trading on inside information he obtained through his employer. This time, however, the court found liability even in the absence of any duty to the shareholders.

In *O'Hagan*, the defendant lawyer worked for an independent law firm representing the bidder in a tender offer. Because *O'Hagan's* firm represented the bidder and not the issuer, *O'Hagan* owed no fiduciary duty to the target's stockholders and could not be prosecuted under the classical theory. The Supreme Court, however, did not give *O'Hagan* a pass, but instead recognized and formulated the now ubiquitous misappropriation theory, holding that *O'Hagan*

Courts may be inclined to go to exceptional lengths to prevent defendants from using what appears to be a clear and logical defense to insider-trading charges.

Rocklage decision raises doubts about the defense and exposes a structural weakness in the misappropriation theory.

Two Theories

There are currently two theories used to prosecute insider trading under §10(b) and SEC Rule 10b-5: the classical theory and the misappropriation theory. The “classical theory” applies to an actual insider who violates the antifraud provisions of the federal securities laws by trading in the securities of

adopted a theory imposing insider trading liability on someone who “misappropriates confidential information for securities trading purposes, in a breach of duty owed to the source of the information.”

Because the misappropriation theory rests on a duty to the source of information rather than to the shareholders of the company, the misappropriation theory sprouted a defense, or “loophole.”

The misappropriation theory results in part from an earlier Supreme Court deci-

■ See **DISCLOSURE** on PAGE 7

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BROKER-DEALER CHARGED UNDER USA PATRIOT ACT

By **DAVID M. LAIGAIE**
and **RICHARD KRAUT**

The Securities and Exchange Commission recently accused a Florida broker-dealer, Park Financial Group Inc., and its principal, Gordon C. Cantley, of violating the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, otherwise known as the USA Patriot Act.

The SEC alleges that Park and Cantley aided and abetted a pump and dump fraud scheme perpetrated by Dennis P. Crowley, the former chief executive officer of Spear & Jackson Inc., a Nevada-based tool maker.

Significantly, the SEC also charged Park and Cantley with violating the anti-money laundering provisions of the USA Patriot Act by failing to file Suspicious Activity Reports (SARs). This is the first time that the SEC has brought an enforcement action based on a broker-dealer's failure to file SARs. The SEC frequently asserts new bases of liability in egregious cases and then exports these bases to more mainstream cases. Broker-dealers, therefore, should expect and pre-

pare for increased scrutiny concerning the filing of SARs.

In April 2002, Congress passed the USA Patriot Act, which amended provisions of the Currency and Foreign Transactions Reporting Act of 1970 (commonly known as the Bank Secrecy Act) and substantially expanded a broker-dealer's obligations to detect and prevent money laundering. Effective Dec. 31, 2002, broker-dealers are responsible to report suspicious transactions by filing a SAR reporting any transaction involving or aggregating at least \$5,000 that it "knows, suspects, or has reason to suspect:" involves funds derived from illegal activity or is conducted to disguise funds derived from illegal activities; is designed to evade any requirements of

the Bank Secrecy Act; has no business or apparent lawful purpose and the broker-dealer knows of no reasonable explanation for the transaction after examining the available facts; or involves use of the broker-dealer to facilitate criminal activity.

Warning Signs

In the Park case, the SEC has chosen an egregious set of facts to trot out its new basis of liability. Park ignored numerous warning signs about the trading in Spear & Jackson stock. The situation began when a Florida-based stock promoter working for Spear & Jackson

referred three British Virgin Island companies to Park. Park never met any of the principals of the BVI companies; it received all account-opening information by mail and all trading instructions by phone.

The BVI companies traded exclusively, nearly daily, and in high volumes, in Spear & Jackson stock. Park accepted orders to sell the BVI companies' shares of Spear & Jackson from Crowley, even though Crowley had no legal relationship to the BVI companies, was not authorized to transact shares on behalf of those companies, and despite the fact that Park knew that Crowley was Spear & Jackson's CEO.

The BVI companies, moreover, transferred a large number of Spear & Jackson stock to the stock promoter. All in all, Park handled more than 200 transactions for the BVI companies, selling an aggregate total of over one million shares and collecting about \$2.5 million in proceeds for the BVI companies. Spear & Jackson's price soared from \$2 per share to \$16 per share during the nearly 18 months while this pump and dump scheme was underway.

In April 2004, the SEC filed charges

David M. Laigaie, a partner at Dilworth Paxson, heads the firm's corporate investigations and white collar group. Richard S. Kraut, a partner in Dilworth Paxson's Washington, D.C., office, is a member of Dilworth Paxson's corporate investigations and white collar group. Kraut previously served as an assistant director of the SEC's division of enforcement.

Action is first based on failure to file suspicious activity reports

against Crowley, Spear & Jackson and the stock promoter. Crowley was ordered to pay \$6 million and was barred from being a director or officer of a public company. The stock promoter was ordered to disgorge over \$2 million, and its two principals were each ordered to pay disgorgement and penalties in excess of \$420,000. Now, three years later, the SEC has filed charges against Park and Cantley. Pursuant to those charges, a hearing will be scheduled before an administrative law judge to determine whether the allegations are true and to determine remedial actions.

Until now, the SEC's enforcement of the USA Patriot Act against broker-dealers focused on their failure either to adopt appropriate anti-money laundering programs or to follow such programs.

For example, last year, the SEC brought an enforcement action against a Los Angeles-based broker-dealer for failing to follow internal policies concerning verifying the identities of new customers. That broker-dealer's policy required it to check government-issued identification before opening new accounts.

The Park case represents a new area of enforcement for the SEC. The commission will undoubtedly increase its SARs enforcement on broker-dealers.

Statistics suggest that broker-dealers are not currently doing an adequate job reporting suspicious activities. For example, in 2005, securities industry participants filed a total of less than 7,000 SARs, as compared to more than 900,000 SARs filed by depository institutions and money services

businesses.

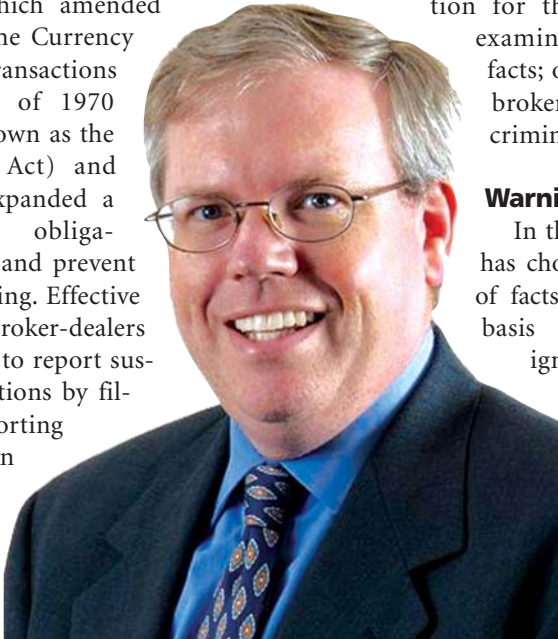
In the face of this enforcement initiative, broker-dealers should do three things to avoid liability.

First, they must ensure that their SAR policy is appropriate, in force and followed.

Second, they should review SARs that they have filed to make sure that they are properly reporting suspicious transactions.

Finally, they should be alert to the public record for criminal, civil or administrative actions (including private litigation) brought against their clients to determine whether they failed to report trading that should have been reported.

If a broker-dealer has not filed any SARs, or few SARs relative to its trading volumes, then the broker-dealer must assume that its SAR policy is failing and correct that failure. ■



Supreme Court's eBay decision increases focus on patent damages

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DISCLOSURE NOT NECESSARILY A LIABILITY SHIELD

■ From **NO EASY WAY** on PAGE 5

could be properly prosecuted for insider trading because he had deceived both his law firm and its client by pretending to be loyal to them while secretly profiting from information obtained from them.

But the court also articulated a defense: "Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no §10(b) violation." 521 U.S. at 655. This "disclosure to the source" defense, which the 1st Circuit in *Rocklage* said was arguably dictum because O'Hagan did not disclose his trading to the firm or its client, ultimately came home to roost in *Rocklage*.

Brother's Helper

In January 2005, the SEC filed an action against Rocklage, her brother and one of his friends for insider trading under the misappropriation theory. The complaint alleged that Rocklage, who had learned negative information about her husband's pharmaceutical company, Cubist, tipped her brother, a Cubist shareholder, about the bad news. That allowed the brother and the friend, who was also a Cubist shareholder, to avoid hundreds of thousands of dollars in losses.

Before she obtained the inside information from her husband, Rocklage had an agreement with her brother that she would "signal" him about any bad news regarding Cubist before it became public. Her husband was apparently unaware of this arrangement. He told her the information was confidential and that she was not to tell anyone.

Nevertheless, after hearing the negative information, Rocklage told her husband that she was going to tip her brother. The husband tried to dissuade her but was unsuccessful. Rocklage's brother and his friend sold their shares ahead of the public disclosure.

The defendants moved to dismiss on the basis of the O'Hagan "disclosure to the source" defense, but the district court found O'Hagan distinguishable. In its initial opinion, the district court had misread the facts of O'Hagan, mistakenly believing that O'Hagan's firm had a duty to the target shareholders when actually the firm represented the bidder. Despite this error, which the district court acknowledged on defendants' motion for reconsideration, it reaffirmed its denial, distinguishing O'Hagan because the marital relationship in *Rocklage* did not give the husband the same ability to take "remedial action" against his wife as could a law firm against O'Hagan. The district court certified the issue for interlocutory appeal to the 1st Circuit.

On appeal, the defendants argued that Rocklage could not be liable for securities fraud because she fell within the O'Hagan disclosure defense. The 1st Circuit rejected this argument and affirmed the lower court's decision on the basis that O'Hagan was indeed distinguishable from the facts of

Rocklage, but for completely different reasons than those expressed by the district court.

The 1st Circuit explained that the "defendants' position is really that because some of Mrs. Rocklage's actions may have been non-deceptive, her scheme as a whole had no deceptive elements. We do not believe that O'Hagan requires such an understanding of §10(b)." Rocklage committed at least two deceptive acts, one when she acquired the information, and the other when she tipped her brother. Consequently, unlike O'Hagan, who only committed one act of deception by trading on information

he had properly obtained through his firm, Rocklage's disclosure cured only part of her previous deception but not all of it. Despite her disclosure to her husband, "her overall scheme was still deceptive: it had as part of it at least one deceptive device."

Although the 1st Circuit engaged in substantial hair-splitting to distinguish the facts of O'Hagan from those in *Rocklage* and thus skirt any interpretation of the O'Hagan "disclosure" defense, the panel urged the Supreme Court to shed light on the confusion created by O'Hagan. The "import and reach of the Supreme Court's language in

O'Hagan about disclosure as a cure for deception has created uncertainty in the courts ... Until the Supreme Court has clarified its language about disclosure, this uncertainty is an important factor in why we are unwilling to state generalized rules."

Until the Supreme Court accepts the 1st Circuit's invitation, courts may be inclined to go to exceptional lengths to prevent defendants from using what appears to be a clear and logical defense to insider trading charges. If this becomes the trend, then disclosure may not set you free or shield you from civil liability. ■

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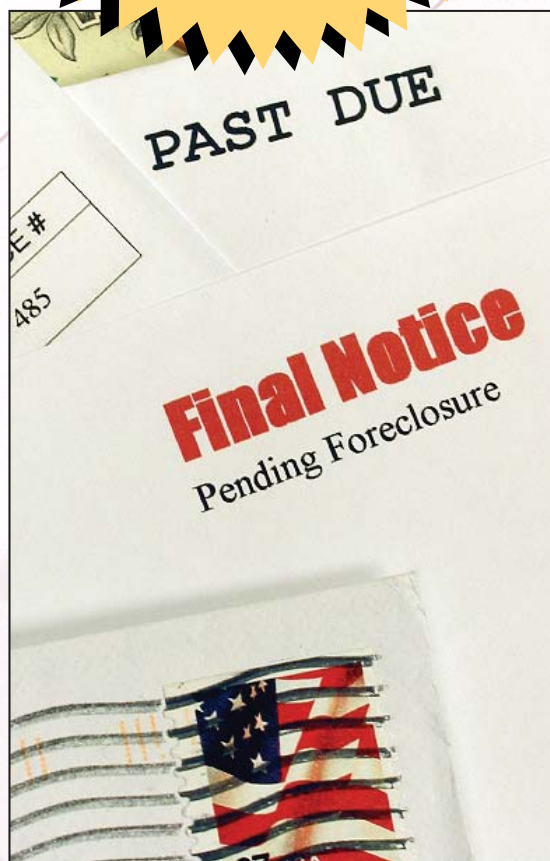
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■ From **LEVERAGED** on PAGE 3

During the trial, Campbell and VFB both introduced economic expert witnesses to estimate the value of Vlastic Foods at the time of the spin. Campbell's expert estimated the value of Vlastic Foods using the comparable company method and concluded that Vlastic Foods was worth between \$1.5 and \$1.8 billion. For its part, VFB presented three experts. VFB's first expert compared Vlastic Foods to a different set of companies than Campbell's expert and estimated that Vlastic Foods was worth \$569 million (before applying a 25 percent illiquidity discount and a 10 percent spin-off discount). That expert also performed a discounted cash flow that valued Vlastic Foods' worth at \$270-360 million. VFB's remaining two experts performed a discounted cash flow that produced a value of \$377 million. Despite the abundance of experts, the district court chose to use the trading price of Vlastic Foods'

regardless of the spin-off as the primary factor in determining reasonably equivalent value. VFB appealed.

In affirming the district court, the Third Circuit held that whether or not a company's market capitalization is inflated is a question of fact that is reviewed for clear error. In the context of the Campbell-Vlastic spin-off, the market was initially misled by Campbell's short-term accounting manipulations, rendering the initial market capitalization an inappropriate yardstick. However, nine months later the market had adjusted itself to the accounting irregularities, and reflected a market capitalization of \$1.1 billion - a figure that reflected a value well in excess of the \$500 million which was received by Campbell under the spin. Further, no party suggested that Vlastic Foods was increasing in value between the time of closing and September 1998. On the contrary, Vlastic Foods was on the decline. Therefore, the Third Circuit reasoned that if an informed-market appraised Vlastic Foods nine months after the spin as being worth in excess of \$500 million and if Vlastic Foods was worth more at the time of the

spin than nine months out, Vlastic Foods must have received reasonably equivalent value at the time of the transfer.

Fiduciary Duties

The duty of loyalty embodies the basic principle that directors must act in the best interests of their constituents and cannot derive any personal benefit through self-dealing. Many jurisdictions, including New Jersey, recognize a cause of action for knowingly aiding and abetting an agent's breach of a duty of loyalty to its principal. Of course, to aid and abet a breach of duty, there must first be both a duty owed and a breach.

VFB alleged that Vlastic Foods' pre-spin directors, who were officers of Campbell who resigned their positions as directors upon closing, breached their fiduciary duty of loyalty by not acting in Vlastic Foods' best interests. In this regard, VFB argued that being both an officer of Campbell and a director of Vlastic Foods should have triggered the heightened scrutiny associated with an agent serving on two sides of the same transaction. The Third Circuit disagreed.

In three basic situations courts have addressed the fiduciary duties imposed on a subsidiary's directors as against the parent: (1) the partially-owned subsidiary (solvent or insolvent), (2) the wholly-owned insolvent subsidiary, and (3) the wholly-owned solvent subsidiary. With respect to a partially-owned subsidiary, it is clear that the subsidiary's directors' duties run to the subsidiary for the benefit of all of the company's shareholders, including the minority shareholders. And a director who sat on both sides of a transaction with the subsidiary's parent would trigger heightened scrutiny by a reviewing court.

Similarly, directors of a wholly-owned insolvent subsidiary owe a duty to the company and its stakeholders, which now include its creditors. Accordingly, a director may not allow an insolvent wholly-owned subsidiary to be harmed for the benefit of the parent to the detriment of the subsidiary's creditors. Put differently, "There is

no basis for the principle . . . that the directors of an insolvent subsidiary can, with impunity, permit it to be plundered for the benefit of its parent corporation."

A solvent wholly-owned subsidiary, on the other hand, is different from the foregoing because it has but one interest holder - its parent. So it makes no sense to say a director owes a fiduciary duty to a solvent wholly-owned subsidiary, who was acting in the interest of the parent, to be loyal to the subsidiary as against the parent. Or as articulated by the Delaware Supreme Court, "in a parent and wholly-owned subsidiary context, the directors of the sub-

subsidiary are obligated only to manage the affairs of the subsidiary in the best interests of the parent and its shareholders."

Based on the court's resolution of the issue of reasonably equivalent value, it concluded that Vlastic Foods was solvent as of the date of the spin-off. As such, Vlastic Foods was a wholly-owned solvent subsidiary of Campbell, and as such, its directors owed a duty of loyalty to the parent only. Accordingly, the directors did not breach their fiduciary duties to Vlastic Foods, and Campbell obviously could not have aided and abetted breaches of fiduciary duties that were not breached. ■

The Third Circuit held that whether or not a company's market capitalization is inflated is a question of fact that is reviewed for clear error.

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