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COMMENTARY

Nine steps to optimization of the audit committee

Officers and directors serving on corporate audit committees should be aware of their increased liability and step carefully in light of a 2010 report that the number of securities suits and the amounts paid to settle them are up sharply, say Barry Jay Epstein and Elaine Vullmahn of Russell Novak & Co.

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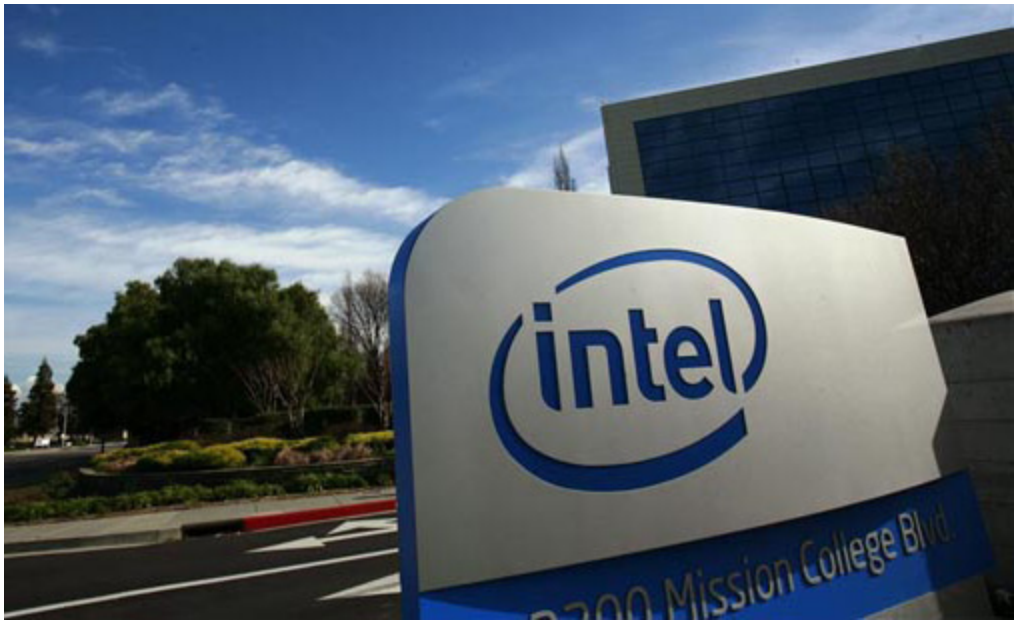

REUTERS/Robert Galbraith

BREACH OF DUTY

McAfee sold its future too cheaply in $7.7 billion Intel deal, suit says

An unfair $7.7 billion merger with Intel Corp. will cut McAfee shareholders out of the cyber security firm's bright and profitable future as most electronic devices link to the Internet, a disgruntled investor charges in state court in San Francisco.

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Editor: Frank Reynolds
Frank.Reynolds@thomsonreuters.com

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Andrews Publications
175 Strafford Avenue
Building 4, Suite 140
Wayne, PA 19087
877-595-0449
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Nine steps to optimization of the audit committee

By Barry Jay Epstein, Ph.D., CPA, and Elaine Vullmahn, MBA, CPA, CIA

Shareholders are becoming increasingly intolerant of inadequate financial disclosures and questionable accounting practices and increasingly are holding audit committees responsible. According to a second-quarter 2010 report by Advisen Ltd., which specializes in research and analytics, the number of securities suit filings "was up sharply — nearly 30 percent higher than the first quarter, and 19 percent above the very active second quarter of 2009."

Advisen also reported that "the average securities class action settlement [through the first half of 2010, compared to 2009] increased materially, from $10.4 million to $49.6 million."

Oversight failures can clearly contribute to severe and even disastrous consequences for individual directors and the companies they serve.

Recently, there have been a number of lapses in oversight that have resulted in poor financial performance for well-regarded corporations. For example, Monsanto Co.'s financial statements are alleged to have masked the agricultural products distributor's true financial condition.

The company and certain of its officers and executives stand accused of failing to adequately disclose to shareholders material adverse facts about the company, including how demand for its products was declining substantially, that prices for herbicide products were going to be cut significantly to compete with a saturating market, and that its reported earnings, prospects and financial condition were substantially misstated.

Separately, a class-action lawsuit was recently filed against Anadarko Petroleum Corp. and certain of its officers and directors. The plaintiffs in that case allege, *inter alia*, that the defendants "issued materially false and misleading statements" and that the company "lacked adequate systems of internal, operational or financial controls."

Many audit committees struggle with discharging their oversight responsibilities in the face of a complicated web of laws and regulations. Rapid business expansion (oftentimes into international markets), continuously changing accounting standards and greater reliance on electronic information systems have further complicated the ability of many ACs to monitor corporate behavior.

ACs can lessen shareholder dissatisfaction and the risk of litigation by learning to function more efficiently and effectively. Prudent ACs can accomplish this, in part, by conducting regular self-evaluations to assess the extent to which they are meeting their responsibilities. The following nine areas are often ripe with possibilities for improvement.

A key committee, like the AC, should include a mix of continuing members and recent additions; it is wise always to retain a few experienced members for needed stability and to serve as the "institutional memory" of actions taken in earlier periods, both successful and those that misfired.

Even with the best of intentions, looking at the same criteria and making repetitive decisions year after year can become mundane to even the most professional governance advisers. Adding occasional "fresh blood" is a means to overcome this tendency. Overall, the AC should strive to function with members who possess an effective amalgam of fresh perspective, knowledge and experience.

Oversight failures can clearly contribute to severe and even disastrous consequences for individual directors and the companies they serve.

COMPOSITION

The AC should regularly review its composition to thwart stagnation and ensure the best-equipped people are serving as active members. Companies subject to Sarbanes-Oxley requirements, of course, must have "financially literate" AC members, of whom at least one need be a financial-reporting expert.

Even entities not affected by this rule would be well advised to seek highly qualified individuals to serve on this key committee and on the full board as well. Financial reporting, and its related control considerations, plays such an important role in the life of an enterprise — even absent the existence of any outside shareholders — that it is well worth the effort to recruit, and the cost to compensate, appropriately qualified individuals.

The AC should also consider rotating members, especially if one or more persons not on the current board desire to contribute to the organization. New members can bring fresh perspectives to evaluating business operations, assessing risk and recommending stronger internal control measures.

BUILDING AND MAINTAINING COMPETENCY

Finding and recruiting qualified AC members is vital, but after being appointed, the members must be given the resources to perform continually at a high level. The rules and concepts pertinent to quality financial reporting are constantly evolving, and steps should be taken to keep AC members actively engaged in continual learning.

For example, on the near-term horizon is the move to replace generally accepted accounting principles with international financial reporting standards, about which almost all U.S.-based AC members (and even the accounting and auditing experts among their ranks) currently have little understanding. Other changes, such as revised Securities and Exchange Commission reporting requirements, will also continue apace.

To address these inevitable changes in the financial-reporting environment, the AC could schedule regular "lunch and learn"

events and presentations tailored to meet members' needs and interests. It is critical that AC members be made aware of changes in their company's business environment, extending to the wider business scope, which could alter risks and opportunities the company faces and affect its financial-reporting needs and strategies.

Attendance at updating and training sessions could be either optional or compulsory depending on topic and company philosophy (although the authors favor the latter). Emphasis should be placed on active participation, even for optional sessions, as meetings featuring active learning can make more effective the participants' abilities to discharge their fiduciary and oversight responsibilities. Use of modern teaching techniques, such as role playing, can prove remarkably effective, even with participants who may otherwise resent being subjected to typical lectures that encourage only passive (and often ineffective) listening.

extent of the commitment, so those unable or unwilling to serve in a substantive manner can be screened out.

OPTIMIZING FREQUENCY AND STRUCTURE OF MEETINGS

ACs should periodically evaluate the productivity of their regular meetings to consider possible changes to meeting structure or frequency. Meetings that are too informal could result in invigorating discussions but inadequate follow-through on the ideas and concerns raised. Meetings that are too formal may inhibit active involvement by participants who may be reluctant to speak up; these meetings tend to become mere box-checking sessions.

Depending on the agenda items, the AC may find that the communication of opinions and comprehension of complex data can be enhanced by having guest speakers, a trained facilitator, or by using videos, detailed PowerPoint presentations and other technology to distribute information relevant to the issues to be discussed.

On the other hand, slickly packaged, even animated, presentations, which have become de rigueur for even routine staff meetings, can be counter-productive and unlikely to foster follow-through, easily devolving into entertaining but non-substantive sessions that encourage passivity.

AC and other board committee meetings are typically scheduled for the same days as full board meetings and may occur four to eight times per year. The adequacy of the current schedule should be periodically reconsidered and adjusted as warranted. Not all committees have the same workload (the audit committee's tasks are often the most demanding), so uniformity of schedules is neither necessary nor wise.

Ultimately, in order to be effective, ACs need to conduct meetings that balance effectively the needs to summarize the status and review the progress of outstanding issues, discuss current agenda items, and assign responsibility for new tasks.

> The committee should regularly review its composition to ensure that stagnation does not occur and that the right people are serving as active members.

AVAILABILITY FOR ADEQUATE TIME COMMITMENT

AC members should reflect on whether or not they have adequate flexibility in their respective schedules to assume the duties and responsibilities entailed in serving on the committee.

If any member finds herself overwhelmed and incapable of handling the added workload, she should bring the issue to the attention of the full board or chairman and, if necessary, resign. AC members should be assured that there is no dishonor in resigning for such reasons, but that continuing to serve in name only, unproductively, would be a disservice to the company and the other members.

There are many benefits gained by accepting a seat on the AC. Such an appointment can enhance a member's reputation and place him or her in a position for career advancement.

ACs can best achieve their goals when their members have sufficient time to devote to discussing and deciding key issues. Potential members should be candidly informed of the

ADEQUACY OF TECHNICAL RESOURCES

Even when composed of highly qualified individuals, it is not realistic to expect that ACs can always be self-sufficient, particularly regarding insights into practices among other ACs, and concerning impending changes to financial-reporting rules and securities laws. This has been underscored by Sarbanes-Oxley, which empowered ACs to engage their own legal and accounting advisers as deemed warranted. Evidence suggests that few ACs have done this to date, which may be explained by the inertia that affects us all.

However, in the event of an incident that raises the specter of audit committee legal exposure (*e.g.*, inadequate financial-statement disclosure allegations), the fact that such expertise was sought out and utilized will corroborate the AC's assertion that it was diligent in its conduct. Indeed, having advisory talent available could well prevent many such problems.

Highly qualified board and AC members typically will carry a cost, particularly if independent (non-management) members are recruited (required for publicly held companies but recommended for others as well). The usual cost/benefit considerations will apply, and the supply of highly qualified individuals is finite.

Board membership and/or meeting fees should be set at a competitive level to ensure the company is able to access needed talent. The cost of qualified board and AC members, and even of outside consultants for the AC, rarely will be material to the company's overall revenues and profits and would almost never be material compared with the cost of defending a suit.

DECISION PROCESSES AND OPERATING PHILOSOPHY

The AC should share a common risk-tolerance philosophy with the board of directors and entity management. Ideally, this can be articulated and explicitly agreed upon, although regrettably in practice this often goes unstated.

A divergence in ideology could jeopardize internal operations and ultimately have external financial-reporting implications if some individuals incorrectly believe that certain interpretations of regulations or specific aggressive actions, for example, are acceptable when this has not been agreed upon.

The AC can limit misunderstandings and confusion regarding how risk should be evaluated and handled by creating a dynamic model to facilitate the decision-making process. Such a model can, and should, be shared with other decision-makers, to promote uniform application of risk policies.

This is not to imply that unanimity of opinion is expected or even particularly desirable. A healthy level of debate serves to surface ideas and concerns, and with appropriate structure for discussion (with the necessary "tone at the top" provided by the board and committee chairs), optimal decisions are more likely to result.

Nonetheless, it is best if an overall philosophy regarding the role and responsibility of the AC, the entity's approach to financial reporting, and so forth, is shared by most or all of the AC members. This will change as membership changes and environmental conditions evolve, of course. When new members are being recruited, candidates should be informed of the current committee's posture on these matters.

INFORMATION SUPPORTING DECISION-MAKING

AC decisions need to be based on the most relevant and reliable information. It is, therefore, wise for ACs to evaluate the processes used for requesting and receiving information. It is essential for members to be able to obtain the decision inputs they need in a timely manner.

When the AC requests documents, data, models, etc., the members should receive this information well in advance of meetings to provide members time for thoughtful consideration. They should also receive materials that are sufficiently detailed and respond satisfactorily to AC member inquiries.

It is not unknown for some management personnel to provide ACs (and other outside members of the boards) with information within a few days of scheduled meetings, sometimes to limit the risk of informed challenges to management members of the board.

Such situations should never be tolerated. ACs must be assertive to control the risk of making suboptimal decisions, which could spawn litigation and other costly, reputation-damaging consequences.

COMMITTEE STRUCTURE AND DUTIES

Each AC should have a clearly defined role within its organization. It is useful for the AC to re-examine its charter periodically, since expectations from when it was written may well have become obsolete. The AC should either recommit to those goals or seek to modify its current structure and obligations, as new circumstances warrant.

It is critical that the AC operate within a framework that enables it to carry out governance responsibilities with efficiency and effectiveness in a manner responsive to changing environmental circumstances. It should be capable of influencing changes within the business's operations so that, among other things, entity risk management is integrated throughout the enterprise. There is a greater opportunity for successful adoption and acceptance of operating changes when management understands the AC's responsibilities and authority, and is confident that these have been updated to reflect current conditions.

COMMUNICATION

Effective communication between the AC and the full board of directors, the internal audit function, management and external auditors is critical to company function. In order to encourage and enforce the free flow of information and continuous dialog among these groups, the AC could establish a schedule reflecting when it expects to receive and communicate information.

For example, the AC could require the internal audit function to report on the findings of internal audit engagements it has performed on a monthly or quarterly basis. The AC can, in turn, utilize that information to discuss with the external auditors the performing of specific procedures during the planned quarterly and year-end audits.

In similar fashion, the AC can establish communications schedules with its other counterparties. Risk mitigation and improved operating practices can be best achieved through frequent communication between groups and putting into use a formal communications calendar.

CONCLUSION

The audit committee is key to the success of the company's business operations. If the AC falters in executing its duties, particularly in the areas of financial reporting and controls over the integrity of the financial-reporting process, there could be grave consequences for the entity.

Without proper governance, monitoring and risk-assessment systems in place, the entity's financial statements may include errors and misrepresentations, which could cause reduced investor confidence, higher cost of capital, litigation and reputation damage.

If attention is paid to the foregoing nine key aspects of AC structure and conduct, the committee will more likely optimize its performance and contribute substantively to the successful operation of the business enterprise it serves. Periodic reviews are useful in coping with dynamic business environments, bringing fresh ideas to the fore and stimulating active participation by AC members. Whether the entity is public or private, a vibrant AC can function as a key determinant of organizational achievement. WJ

Barry Jay Epstein, Ph.D., CPA, is partner in the Chicago firm **Russell Novak & Co.**, where his practice is concentrated on technical consultations on GAAP and IFRS, and he is a consulting and testifying expert on civil and white-collar criminal litigation matters. Epstein is the co-author of Wiley GAAP 2010, Wiley IFRS 2010, Wiley IFRS Policies and Procedures, the WG&L Handbook of Accounting and Auditing, and other books. He can be reached at bepstein@RNCO.com. **Elaine Vullmahn**, MBA, CPA, CIA, is a senior litigation accountant with the firm, specializing in internal control matters and litigation consulting. She is also a juris doctorate candidate at the John Marshall Law School, class of 2011.

McAfee

CONTINUED FROM PAGE 1

Greenberg v. McAfee Inc. et al., No. 10-180413, complaint filed (Cal. Super. Ct., Santa Clara County Aug. 19, 2010).

The class-action lawsuit by shareholder Fred Greenberg asks the Santa Clara County Superior Court to enjoin a $48-per-share offer from Intel until the McAfee board fulfills its fiduciary duty to seek out the best price for the company.

> McAfee CEO David DeWalt and his overly compliant board of directors agreed to various deal-protection devices to discourage other bidders, the suit says.

The suit claims that instead of pressing microprocessor maker Intel for a better offer, the McAfee officers and directors thought more about the lucrative change-of-control benefits and future positions they would reap in the merger, which will create a hardware and software giant.

Even worse, Greenberg complains, CEO David DeWalt and his overly compliant board of directors agreed to various deal-protection devices to discourage other bidders from coming forward. For example, McAfee allegedly:

- Will not shop around for better bids or encourage superior offers from other parties.
- Will give Intel the right to match any offer that does come in.
- Will require any successful competing bidder to pay a $230 million termination fee to compensate Intel for losing the deal.

Although located in California, McAfee is chartered in Delaware, so its directors must fulfill the duty that state's corporate law imposes on them to maximize shareholder value in any sale of the company, Greenberg asserts.

In a press release announcing approval of the deal by both boards of directors, Intel CEO Paul Otellini said, "With the rapid expansion of growth across a vast array of Internet-connected devices, more and more of the elements of our lives have moved online."

DeWalt commented on the deal in his own statement.

"The cyber-threat landscape has changed dramatically over the past few years, with millions of new threats appearing every month. We believe this acquisition will result in our ability to deliver a safer, more secure and trusted Internet-enabled device experience," he said.

The suit asks the court to enjoin any shareholder vote on the deal at least until the McAfee board is free to shop for the best price. WJ

Attorneys:
Plaintiffs: Marc Umeda, Stephen Oddo, Rebecca Peterson and Arshan Amiri, Robbins Umeda LLP, San Diego; Mark Gardy and James Notis, Gardy & Notis, Englewood Cliffs, N.J.

Barnes & Noble's poison pill was reasonable response to threat, court says

Barnes & Noble Inc.'s directors were justified in using a poison-pill defense to block a possible "creeping takeover" by activist investor Ron Burkle after he accumulated nearly 20 percent of the bookseller's stock, a Delaware state court judge has ruled.

Yucaipa American Alliance Fund II L.P. et al. v. Riggio et al., No. 5465, 2010 WL 3170806 (Del. Ch. Aug. 11, 2010).

Vice Chancellor Leo Strine rejected a request by Burkle's Yucaipa American Alliance Fund II to enjoin the directors from using that defense.

HOW BIG A THREAT?

Burkle testified at a Chancery Court trial there was no threat to thwart because he had no interest in controlling Barnes & Noble, but the judge noted Burkle's Barnes & Noble holdings rapidly rose in proportion to his dissatisfaction with the firm's management decisions.

The reasonableness of the Barnes & Noble board's adoption of the pill was a key issue in the case — one of the most closely watched merger battles since the 2008 meltdown of the financial industry.

Vice Chancellor Strine found that "in response to this threat that the corporation's stockholders would relinquish control through a creeping acquisition without the benefit of receiving a control premium, the board adopted a measured pill" that did not bar Burkle's proxy contest plans.

AN EXTRA-POISONOUS PILL?

A poison pill, also known as a shareholder-rights plan, triggers when an uninvited investor buys more than a set percentage of the company's stock (20 percent in this case) and creates thousands of new shares at a discount to all shareholders except the hostile suitor.

However, the Barnes & Noble pill also explodes if a group of investors who collectively own 20 percent or more of the company's stock act in concert to elect directors or change the corporate charter, the breach-of-duty suit filed by Yucaipa and a related entity alleges.

Burkle and Yucaipa argued at trial that feature of the pill will make it difficult to act in concert with other dissidents to support a slate of director candidates at the next annual shareholder meeting, scheduled to take place sometime before Sept. 30.

The incumbent directors that Burkle hopes to unseat support Board Chairman Leonard Riggio, whose family owns a controlling share of the company.

WHO'S IN CONTROL HERE?

Although the suit claims the board is dominated by Riggio, Yucaipa does not say a majority of the directors lack independence because it knows it cannot prove that charge, the defendants said in their pretrial brief.

The fact that the majority of the board members are independent means the court must give their decisions a higher level of deference, the defendants say.

Vice Chancellor Strine's exhaustive 89-page opinion details a long history of conflict in business relations between Burkle and Riggio that escalated when Burkle learned Riggio had sold a college book company he controlled to Barnes & Noble in what Burkle called a "self-dealing transaction."

Burkle "repeatedly indicated in public filings and letters to the board that he intended to effect changes in the company's governance and reserved the right to buy up to 50 percent" of the company, the court pointed out concerning Burkle's intentions.

THE BACK DOOR TO CONTROL?

Moreover, the pill the Barnes & Noble directors adopted will not bar Burkle from mounting a proxy contest that very well could let him in the back door to control of the Barnes & Noble boardroom, the court said.

"Indeed, the record indicates that even with the pill in place, Yucaipa not only has a reasonable chance to, but is in fact likely to, prevail in a proxy contest if it runs a credible slate of candidates," the judge wrote. "Thus the board's decision to use the pill ... was reasonable." WJ

Attorneys:
Plaintiffs: David McBride, Martin Lessner, Kristen DePalma, James Higgins, James Yoch Jr., Kathaleen McCormick, Megan Haney, Richard Thomas, Nicholas Rohrer, Melanie Sharp and Emily Burton, Young Conaway Stargatt & Taylor, Wilmington, Del.; Stephen Alexander, Beth Boland, J. Warren Rissier, Matthew Lawson and Karen Pazzani, Bingham McCutchen LLP, Los Angeles

Defendants (Barnes & Noble): Peter Walsh Jr., Michael Pittenger, Dawn Jones, William Green Jr. and Ryan Browning, Potter Anderson & Corroon, Wilmington; Sandra Goldstein and Kevin Orsini, Cravath, Swaine & Moore, New York

Defendants (Riggio): Gregory Williams, Lisa Schmidt and Blake Rohrbacher, Richards, Layton & Finger, Wilmington; Eric Rieder and John Kircher, Bryan Cave LLP, New York

Defendants (other individual defendants): Kenneth Nachbar, Susan Waesco and Shannon German, Morris, Nichols, Arsht & Tunnell, Wilmington

Related Court Document:
Opinion: 2010 WL 3170806

REUTERS/Lily Bowers

FIDUCIARY DUTY

Shareholder says drug firms' $168 million merger is 'unfair'

A drug development company that specializes in treating nervous system disorders is selling itself too cheaply through an unfair sales process, a shareholder claims in Washington state court.

Jackson v. Penwest Pharmaceuticals Co. et al., No. 10-2-29162-8 SEA, complaint filed (Wash. Super. Ct., King County Aug. 11, 2010).

Steve Jackson sued Penwest Pharmaceuticals Co., its board of directors and the company's largest shareholders for self-dealing and unjust enrichment in the company's proposed $168 million sale to Endo Pharmaceuticals Holdings Inc.

Earlier this month Penwest announced that it entered into a merger agreement in which Endo, its long-time partner in the development and commercialization of the drug Opana ER, agreed to buy all its common stock for $5 per share.

Penwest's board of directors unanimously approved the deal, and the offer represents a premium of 19 percent over the closing price of the company's stock Aug. 6, according to the complaint in the King County Superior Court.

But Jackson says the sales price "does not adequately reflect the company's prospects going forward."

He notes that the company's stock price has been steadily rising since it bottomed out with the rest of the public markets in November 2008.

The company also has a number of pipeline drugs in development that it anticipates putting out over the near term, according to Jackson.

"If the defendants are able to consummate the proposed acquisition, however, the company's public shareholders will not be able to share in the future success of the company," Jackson charges in the complaint.

> The lawsuit accuses Penwest's largest shareholders of pushing the company into a sales transaction so that they can "monetize their illiquid holdings in the company as quickly as possible."

His suit also names Penwest's largest shareholders, Tang Capital Partners L.P. and Perceptive Life Sciences Master Fund Ltd., as defendants.

It alleges that both Tang and PLS are pushing the company into a sales transaction so that they can "monetize their illiquid holdings in the company as quickly as possible."

Jackson seeks a court order enjoining the transaction "unless and until the company adopts and implements a fair sales procedure or process." WJ

Attorneys:
Plaintiff: Karl P. Barth and Steve W. Berman, Hagens Berman Sobol Shapiro, Seattle; Darren J. Robbins, Randall J. Baron, A. Rick Atwood Jr., David T. Wissbroecker, David A. Knotts and Eun Jin Lee, Robbins Geller Rudman & Dowd, San Diego; Richard A. Maniskas, Ryan & Maniskas, Wayne, Pa.

Related Court Document:
Complaint: 2010 WL 3281076

See Document Section A (P. 17) for the complaint.

SUBPRIME

Raymond James Financial wins dismissal of subprime fraud suit

A New York federal judge has tossed a shareholder suit alleging Raymond James Financial fraudulently failed to set aside enough cash to cover its subprime mortgage losses.

Woodward v. Raymond James Financial Inc. et al., No. 09-CV-5347, 2010 WL 3239411 (S.D.N.Y. Aug. 16, 2010).

The 2009 class-action suit said Florida-based RJF and top executives understated the subprime loan-loss reserves of a subsidiary, Raymond James Bank, in order to inflate RJF's revenue during a 12-month period ending in April 2009.

The plaintiff shareholders, led by the Louisiana School Employees' Retirement System, say they paid an artificially inflated price for RJF stock during that time.

In an Aug. 16 decision U.S. District Judge Robert Patterson of the Southern District of New York dismissed the suit, finding it did not meet federal pleading standards for securities fraud.

RJF's allegedly false statements about loss reserves "are without exception general statements of optimism," the judge said. "This in and of itself renders these statements inactionable."

According to the complaint, RJF announced April 14, 2009, that its second-quarter financial results for that year would be well below the consensus estimates of stock market analysts.

The company also announced that both its commercial and residential loan portfolios would require higher loss reserves, tripling from the first quarter, the suit said.

In response to the unexpected sharp increase in loan-loss provisions, RJF's common shares fell more than 13 percent overnight to close at about $16.50 each April 15, it said.

During the class period RJF shares traded as high as $38 each.

They are currently trading around $25 each.

The plaintiff retirement system says shareholders lost hundreds of millions of dollars because of the alleged fraud.

The executives named in the suit were RJF CEO Thomas A. James and CFO Jeffrey Julien and RJ Bank CEO Steven Raney and Senior Vice President Mark Moody.

The complaint alleged the defendants violated the anti-fraud provisions of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78t(a). WJ

Related Court Document:
Opinion: 2010 WL 3239411

See Document Section B (P. 27) for the opinion.

REUTERS/Lucas Jackson

SUBPRIME

JPMorgan asks judge to boot subprime mortgage suit

JPMorgan Chase is urging a federal judge to dismiss an amended investor suit alleging it fraudulently sold purported investment-grade mortgage-backed securities in 2008 that were "junk bonds."

Fort Worth Employees' Retirement Fund v. JPMorgan Chase & Co. et al., No. 09-CV-3701, memo supporting dismissal filed (S.D.N.Y. Aug. 9, 2010).

The class-action suit, originally filed in New York state court, alleges JPMorgan violated the federal Securities Act of 1933, 15 U.S.C. § 77a, by making misleading statements in securities offering documents concerning the quality of underlying mortgages.

JPMorgan removed the suit to the U.S. District Court for the Southern District of New York, where the case is pending before U.S. District Judge John G. Koeltl.

The court-appointed lead plaintiff, an employee pension fund based in the Virgin Islands, filed an amended complaint in July.

According to the suit, the offering documents failed to disclose that loan originators, including now-bankrupt lender American Home Mortgage Corp., ignored their underwriting and property-appraisal standards.

JPMorgan likewise ignored its loan-purchasing guidelines in acquiring the risky loans for securitization, the suit says.

The securities, called mortgage pass-through certificates, pay dividends drawn from principal and interest payments made by borrowers whose loans have been bundled into a trust.

> The offering documents allegedly failed to disclose that mortgage lenders ignored their underwriting and property-appraisal standards.

In a recent motion to dismiss the suit, JPMorgan says the plaintiff is a "sophisticated investor" that bought the securities knowing a subprime mortgage meltdown was underway.

"Plaintiff has no grounds for a lawsuit where it was fully informed of the risks of its investment but, in hindsight, would prefer not to have made the investment," JPMorgan says in a memo supporting dismissal.

Eleven separate trusts sold investors hundreds of millions of dollars worth of certificates that fell in value as the subprime mortgage crisis unfolded in 2007, according to the complaint.

The plaintiff fund seeks compensation on behalf of investors who relied on the offering documents in buying the certificates.

The suit also names as defendants six JPMorgan executives who allegedly signed the documents. WJ

Attorneys:
Plaintiff: Samuel H. Rudman, David A. Rosenfeld, Carolina C. Torres and Jarrett S. Charo, Robbins Geller Rudman & Dowd, Melville, N.Y.; Arthur C. Leahy, Thomas E. Egler, Susan G. Taylor, Scott H. Saham, Nathan R. Lindell and Matthew I. Alpert, Robbins Geller Rudman & Dowd, San Diego

Defendants: A. Robert Pietrzak, Dorothy J. Spenner and Owen H. Smith, Sidley Austin LLP, New York

Related Court Document:
Memo supporting dismissal: 2010 WL 3253993

Delaware high court says ruling did not make it too tough to use records action

A recent Delaware state court decision did not set the bar too high for dissident shareholders to show a "credible basis" to suspect wrongdoing by corporate officials and demand an inspection of company records, the full Delaware Supreme Court has ruled.

City of Westland Police & Fire Retirement System v. Axcelis Technologies Inc., No. 594-2009, 2010 WL 3157143 (Del. Aug. 11, 2010).

The high court rejected an appeal from Axcelis Technologies stockholders who claimed that if the Chancery Court decision that dismissed their suit stood, the right of all investors to inspect corporate records for evidence of misconduct will be "worthless."

REASON FOR SUSPICION

Delaware, where Axcelis and the majority of the nation's large companies are incorporated, allows shareholders to access company records to communicate with other investors or to find evidence to support a suspicion of wrongdoing.

However, the shareholders must be able to show they have a "credible basis," that is, something to back up that suspicion. Several recent books-and-records cases in the Delaware state courts have focused on what that standard for suspicion should be.

This case has been closely watched by corporate law specialists because it springs from a dispute over shareholder proxy voting, a controversial area where state law, corporate governance rules and federal securities laws intersect.

Shareholder activist groups have urged the Obama administration to instruct the Securities and Exchange Commission to more tightly regulate proxy voting to offset what they see as the Delaware courts' tendency to give corporate management too much latitude in that area.

UNPOPULAR DECISIONS

This case arose after the majority of the Axcelis board spurned a 2008 merger bid by Sumitomo Heavy Industries and allegedly prevented shareholders from accepting the offer.

Dissident shareholders successfully organ-ized a proxy vote to withhold support from three of the directors on the board and, under the company charter, those directors should have been required to step down after that vote of no confidence, according the dissidents.

The board refused to accept the directors' resignations and thereby allowed them to stay on, the shareholders said.

THE BENEFIT OF THE DOUBT

One of the dissident shareholders, the City of Westland Police & Fire Retirement System, filed a books-and-records action, seeking evidence that the incumbent directors had mismanaged the company by thwarting the investors' will, but the Chancery Court granted the company's motion to dismiss.

Vice Chancellor John Noble said the business judgment rule gives the decisions of officers and directors of Delaware corporations the benefit of the doubt unless there is evidence of self-interest or irresponsibility.

However, on appeal, Westland said that rule does not apply to the challenged decisions in this case.

Writing for Chief Justice Myron Steele and Justices Carolyn Berger, Randy Holland and Henry duPont Ridgely, Justice Jack Jacobs said the board's refusal of the merger offer and resignations was well within the powers granted the directors under the company charter and Delaware law.

The plaintiff urged the high court to adopt a standard that "improperly attempts to shift to Axcelis Westland's burden to establish a proper purpose" for the inspection, Justice Jacobs wrote.

However, the high court noted that in other circumstances with a different fact pattern, a board's rejection of a shareholder mandate, such as the vote of no confidence in this case, could be sufficient justification for a records inspection. WJ

Attorneys:
Plaintiff: Jay Eisenhofer, Michael Barry and Christian Keeney, Grant & Eisenhofer, Wilmington, Del.

Defendant: John Reed, Paul Brown, K. Tyler O'Connell and Aleine Porterfield, Edwards Angell Palmer & Dodge, Wilmington.

Related Court Document:
Opinion: 2010 WL 3157143

Justice Jack Jacobs said the board's refusal of the merger offer and resignations was well within the powers granted the directors under the company charter and Delaware law.

Morgan Stanley shareholder seeks directors' reason for dismissal move

A public employees retirement fund that invested in Morgan Stanley & Co. is asking the Delaware Chancery Court to order the investment bank to turn over all records detailing the board's decision to seek the dismissal of the fund's federal shareholder derivative suit.

REUTERS/Brendan McDermid

Louisiana Municipal Police Employees Retirement System v. Morgan Stanley & Co., No. 5682, complaint filed (Del. Ch. July 30, 2010).

The pension fund hopes to use the information it gets in its Delaware books-and-records action to pass a so-called "pre-suit demand" test in its federal derivative suit in New York.

To clear that procedural threshold, shareholder plaintiffs who sue in the name of the company must either give the directors the opportunity to review the suit's charges or show that the board members lacked the objectivity to judge the claims fairly.

In cases like this one, where the directors have invoked their power to move to dismiss the suit for failure to make a pre-suit demand, the plaintiffs must show that the board wrongly rejected their charges because the directors themselves may face liability.

In the Delaware action, the Louisiana Municipal Police Employees Retirement System says it has the right to find out why Morgan Stanley's board of directors decided to reject the pension fund's request for an investigation into alleged wrongdoing.

Shareholders of Delaware-chartered companies such as Morgan Stanley have the right to inspect the company's books and records if they can show that they have a valid purpose such as confirming suspicion of misconduct.

The pension fund says it needed access to company records to investigate allegations that Morgan Stanley officers and directors engaged in reckless trading in auction-rate securities from at least 2006 to 2008 at the expense of its shareholders.

The Chancery Court complaint, filed July 30, arises from a federal judge's dismissal of the retirement fund's 2008 shareholder derivative lawsuit against the Morgan Stanley directors. *La. Mun. Police Employees Ret. Sys. v. Mack et al.*, No. 08-7587, *complaint filed* (S.D.N.Y. Aug. 27, 2008).

U.S. District Judge Alvin K. Hellerstein of the Southern District of New York said the fund had not shown that it would have been futile to make a pre-suit demand on the Morgan Stanley board.

To show futility, the plaintiffs must make a case that a majority of the board members have conflicting interests and thus cannot make a sound business decision about whether to investigate the allegations themselves.

In his ruling Judge Hellerstein specifically invited the retirement fund to make such a pre-suit demand on the Morgan Stanley directors and he set a deadline for doing so.

He even suggested that the parties' attorneys meet to exchange points of view, a suggestion to which Morgan Stanley's attorney "readily acceded" at the court hearing, according to the Chancery Court complaint.

The retirement fund did as the judge suggested and proceeded with the demand only to run into numerous delays over the course of most of the next year, the complaint says.

The Morgan Stanley board told the fund April 26 that it had considered the demand and rejected it in its entirety. The fund says the board has not disclosed its reason for rejecting the demand other than to claim that the federal judge's deadlines had passed.

Now the retirement fund is asking the Chancery Court to issue an order permitting it to inspect all the books and records relevant to board meetings and discussions that would reveal the board's reasoning for denying the pre-suit demand.

Under 8 Del. C. § 220, a shareholder is entitled to explore the board's reasoning for rejecting the demand and to determine for itself whether it can assert derivative claims "on the grounds that the board wrongfully refused to act on the demand," the complaint says. WJ

Attorney:
Plaintiffs: Robert D. Goldberg, Biggs & Battaglia, Wilmington, Del.

R. Allen Stanford arrives at the federal court in Houston Aug. 24 for a hearing before U.S. District Judge Nancy Atlas. REUTERS/Richard Carson

D&O INSURANCE

Texas hearing focuses on whether Stanford scheme included money laundering

A federal judge in Houston must decide whether R. Allen Stanford's alleged schemes included money laundering, which would excuse a D&O insurer from paying the legal bills the banking executive and his lieutenants are running up in a host of civil and criminal actions.

Pendergest-Holt et al. v. Certain Underwriters at Lloyd's of London et al., No. 09-3712, preliminary injunction hearing held (S.D. Tex. Aug. 24, 2010).

U.S. District Judge Nancy Atlas began a special preliminary injunction hearing Aug. 24 in the Southern District of Texas on the narrow issue of the applicability of the money laundering exemption in a $100 million director and officer insurance policy.

The 5th U.S. Circuit Court of Appeals had ruled that a D&O insurer must pay for the defense of Stanford and his top officers but only until a judge decides whether their alleged Ponzi scheme included money laundering — a crime excluded under the D&O policy.

NO LONG, EXPENSIVE WAIT

That appeals court ruling upheld a federal judge in Houston who earlier said the officers should be entitled to defense costs until there is a determination that the money laundering clause applies.

However, the appeals court said the insurer could have a long and expensive wait for that final determination unless a separate federal judge in Houston held hearings and decided the issue on an expedited basis.

A LOT OF LEGAL BILLS

Stanford was chairman of the board of Stanford International Bank. His co-defendants, Laura Pendergest-Holt, Gilbert Lopez Jr. and Mark Kuhrt, were officers of related entities.

A year ago the Securities and Exchange Commission filed civil charges against the four people, along with another person who is not involved in the insurance coverage case.

> "The stay of discovery plaintiffs seek is one-sided and would impose an undue hardship," the judge said.

The SEC alleged the defendants used the Stanford entities to run a massive Ponzi scheme that cheated investors by selling fraudulent certificates of deposit.

Several months later a federal grand jury in Texas handed down a 21-count indictment against Stanford, Pendergest-Holt, Lopez and Kuhrt and that fifth person, alleging mail and wire fraud, securities fraud, money laundering, and obstruction of an SEC investigation. Trial in that case is set to begin in January 2011.

THE COVERAGE ACTION

In November Stanford, Pendergest-Holt, Lopez and Kuhrt filed this suit in the Southern District of Texas against Certain Underwriters at Lloyd's of London and Arch Specialty Insurance Co., which issued a $5 million D&O liability policy and an excess D&O policy to the Stanford entities.

The value of the excess policy is unclear, but according to court records, Lloyd's says it eventually could be on the hook for up to $100 million. Lloyd's had been advancing defense costs to attorneys for Stanford, Pendergest-Holt, Lopez and Kuhrt but stopped doing so last November, the complaint said.

The four plaintiffs in this coverage action moved for a preliminary injunction to require Lloyd's to immediately resume paying their defense costs.

WHO DECIDES HOW MUCH IS ENOUGH?

The central question the special judge must answer regarding the exemption is what standard of proof is necessary to justify a determination that money laundering took place and who is entitled to make it.

In gathering ammunition for the preliminary injunction hearing, Lloyd's sought discovery from the Stanford officers, which they objected to as self-incriminating. The officials said the answers could be used against them in various other proceedings.

In an Aug. 11 ruling on the discovery squabble, Judge Atlas denied the officers' request for a protective order because it was too broad.

"The stay of discovery plaintiffs seek is one-sided and would impose an undue hardship," Judge Atlas said. "Plaintiffs seek to continue pursuing relief while depriving [Lloyd's] of information that may be valuable." WJ

Attorneys:
Plaintiffs: Lee Shidlofsky, Alan Cohen and Douglas Skelley, Visser Shidlofsky LLP, Austin, Texas; Kenneth Broughton Jr., Haynes & Boone, Houston; Henry Fasthoff IV, Stumpf Cannon Fasthoff, Houston; Michael Essmyer, Essmyer Tritico & Rainey, Houston; Robert Bennett, Bennett Law Firm, Houston

Defendants: Barry Chasnoff and Daniel Lane Jr., Akin Gump, San Antonio

Related Court Document:
Order: 2010 WL 3199355

See Document Section C (P. 35) for the order.

D&O INSURANCE

'Insured vs. insured' exclusion includes company and subsidiaries

A federal judge in Illinois is standing by his decision that a D&O insurer need not cover the defense costs of Strategic Capital Bancorp officials for an underlying suit in which the shareholder plaintiffs were ex-directors of SCB or its subsidiaries.

Strategic Capital Bancorp v. St. Paul Mercury Insurance Co. et al., No. 10-2062, 2010 WL 3025146 (C.D. Ill. Aug. 2, 2010).

Chief U.S. District Judge Michael McCuskey of the Central District of Illinois denied the bank directors' motion to reconsider his July 1 decision.

In that ruling he said he could not issue a preliminary injunction against St. Paul Mercury Insurance Co. to force it to pay for their defense in a securities fraud suit. *Strategic Capital Bancorp. et al. v. St. Paul Mercury Insurance Co. et al.*, 2010 WL 2663083 (C.D. Ill. July 1, 2010).

The judge was not persuaded by the ex-officers' argument on reconsideration that they were never directors of the bank holding company SCB and therefore were not covered by the "insured vs. insured" exclusion in St. Paul's policy.

The exclusion bars coverage for claims where one insured party sues another individual or entity that is insured under the same policy. The clause, which is common in D&O policies, discourages suits by or against officers and directors who have been ousted by takeovers or rival shareholder factions.

NO DISTINCTION FOR SUBSIDIARY SERVICE

The underlying shareholder suits, which were consolidated in an Illinois state court, alleged that SCB officers and directors made fraudulent misrepresentations and omissions concerning a private securities offering.

SCB sought coverage from St. Paul under its D&O policy, but the insurer declined because both the defendants and some of the plaintiffs in that consolidated underlying suit were insured under the policy.

When SCB filed this coverage action and sought a preliminary injunction that would force the insurer to at least pay the officer's defense costs, St. Paul argued that the insured-vs.-insured clause barred any coverage.

NO COVERAGE FOR EX-SCB DIRECTORS

Three of the five plaintiffs in the underlying consolidated suit are former SCB directors, whose claims represent 81 percent of the total damages sought, Judge McCuskey noted.

That is significant, he said in the July 1 opinion, because all the case law that SCB cites in support of its position involves underlying actions where current or former officers or directors were in the minority among the plaintiffs in the underlying suits.

In their motion for reconsideration the directors argued that there was no majority of insured directors in the underlying suit because three of the alleged SCB directors were only directors of various SCB subsidiaries and related entities at the time the underlying suits were filed.

Three of those ex-directors were at one time directors of Strategic Capital Bank or Strategic Capital Trust Co. but not Strategic Capital Bancorp itself.

In addition, one ex-director filed suit in the underlying consolidated action in her capacity as a trustee, rather than as an individual. That means that, as a plaintiff, she was acting as a separate entity from her individual capacity as a director, the directors argued in their joint motion.

A DISTINCTION WITHOUT A DIFFERENCE

In its response, St. Paul maintained that the policy makes no distinction between the company and its subsidiaries and does not distinguish between acts a director took in her individual capacity and those taken as a trustee.

Judge McCuskey said there was no mistake in the July 1 opinion. St Paul's policy does not distinguish between a company and its subsidiaries, and neither will the court, he said.

Similarly, there is not enough distinction between the actions of a director and the actions of a director acting through a trust to make any difference as to coverage, the judge ruled. WJ

Attorneys:
Plaintiffs: David Bailie, Thomas Mamer & Haughey, Champaign, Ill.

Defendants: Matthew Previn and Victoria Holstein-Childress, Buckley Sandler LLP, Washington; Kevin Kuhn, Vedder Price PC, Chicago; James Martinkus, Erwin Martinkus & Cole, Champaign; Michael Loeffler, Loeffler Thomas Touzalin LLP, Northbrook, Ill.; Joseph Phebus and William Graham Jr., Phebus & Koester, Urbana, Ill.

Related Court Document:
Opinion: 2010 WL 3025146

Feds finalize 'horizontal merger' guidelines

The Department of Justice's Antitrust Division and the Federal Trade Commission have released final "horizontal merger" guidelines that outline how they will evaluate the likely competitive effects of mergers between firms.

The guidelines, which were first proposed in April and finalized this month, are designed to more accurately reflect the way the agencies currently conduct horizontal-merger reviews.

The revisions are a product of a joint effort between the agencies after soliciting feed-back through five public workshops in 2009 and early 2010.

They mark the first major revision of the merger guidelines in 18 years, according to the FTC's website.

"The guidelines provide more clarity and transparency, and will provide businesses with an even greater understanding of how we review transactions," Assistant Attorney General Christine Varney said in a statement Aug. 19.

The revisions include several key changes, including that the agencies have moved away from a structured market analysis that used a "single methodology."

The guidelines say the agencies will now tend to use a "fact-specific process" that includes a variety of tools to determine whether a merger may substantially lessen competition.

The guidelines also say the definition of each company's market share is "not an end itself or a necessary starting point of a merger analysis." Market concentration is a tool that is useful to the extent it illuminates the merger's likely competitive effects, the announcement said.

Instead it should be considered more as just another tool that is useful to the extent that it "illuminates the merger's likely competitive effects," according to the guidelines.

The new rules also include an updated section on how the agencies evaluate unilateral competitive effects, including the role of innovation in products and business methods.

They also provide a brief discussion on how the agencies evaluate whether entry into a relevant market is easy enough to combat the chances of a proposed merger leading to enhanced market power.

A copy of the new guidelines can be found at www.ftc.gov. WJ

"The guidelines provide more clarity and transparency," Assistant Attorney General Christine Varney said.

SMALL BUSINESS PAID $105 BILLION IN LIABILITY COSTS, GROUP SAYS

A new study by the pro-business U.S. Chamber Institute for Legal Reform says small American companies were burdened by $105 billion in tort liability costs in 2008. Small businesses also paid a total of almost $36 billion in litigation liability costs out of their own pockets instead of recouping the costs through their insurance carriers, according to ILR's July 8 release. Such liability costs are expected to increase to as much as $152 billion by 2011, the report said. "As America struggles out of this current economic downturn, this study shows that our lawsuit system continues to be a drag on job-creating small businesses," ILR President Lisa Rickard said in a statement. The report defines a small business as one with $10 million or less in annual revenue. It is available at www.instituteforlegalreform.com. The ILR is an affiliate of the U.S. Chamber of Commerce.

FEDS APPOINT MONITOR TO OVERSEE DOW DIVESTITURES

The Federal Trade Commission has appointed an interim monitor to ensure that Dow Chemical Co. follows through on the terms of a prior settlement resolving competitive concerns raised by its $18.8 billion merger with Rohm & Haas. In a statement the FTC said Richard M. Klein will oversee Dow's compliance with its obligations under the settlement. Reached in January 2009, the settlement ordered Dow to divest assets related to its acrylic acid monomers, latex polymers, latex traffic paint and hollow sphere particles businesses before the agency would sign off on the company's merger. The FTC has since approved divestitures of these businesses to Arkema Inc. and to OMNOVA Solutions Inc. Klein will keep the FTC staff apprised of "any technical or other problems" that might arise from the settlement order and divestiture agreements, according to the commission.

In the Matter of Dow Chemical Co., No. 081-0214, interim monitor appointed (F.T.C. July 9, 2010).

DEL. HIGH COURT REJECTS APPEAL IN INSURANCE DISPUTE

In a dispute over the extent of excess insurance coverage in asbestos-related personal injury litigation, the Delaware Supreme Court has rejected as interlocutory an appeal brought by several insurance companies. The companies objected to the state Chancery Court's transfer of the case to the New Castle County Superior Court. The Chancery Court handles cases in equity, and the Superior Court serves as the trial court in non-equity cases. The high court said the parties' right to appeal rulings by the Superior Court is preserved and may take place following a final judgment or order.

Century Indemnity Co. et al. v. Viking Pump Inc. et al., No. 424-2010, appeal rejected (Del. July 22, 2010).

CASE AND DOCUMENT INDEX