

Letter from
the President

My father was disappointed when I announced my intention to leave behind a Regular Army Commission in the Medical Service Corps to become a lawyer. He had been a career officer and hospital administrator and shared the all-too-prevalent view that lawyers are the source of, rather than the solution to, problems.



William E. Wegner

While I had never met a real lawyer, I decided to attend law school; I intuitively felt my Dad was wrong. After fifteen years of practice, I know he was. Lawyers stand at the apex of every important dispute, drama, and human endeavor in our society. It is little wonder that those who do not practice law or spend the time examining the process our society employs to resolve disputes and advance human enterprise, confuse the lawyer with the problem.

More frequently, the lawyer is confused with the position he or she is called upon to advocate. The lawyer and the profession become the lightning rod for the frustration or disapproval felt for the positions or values being advanced.

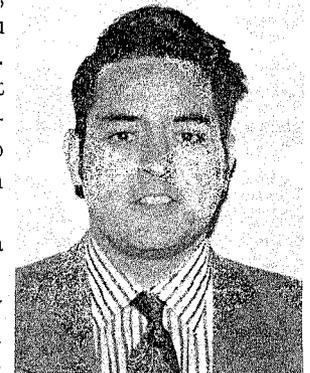
It's the damn lawyers. Eliminate them, and you eliminate the problem.

Eliminate the lawyers and you eliminate the ability of free people to solve problems, especially important problems involving strongly held and inconsistent values or positions. Tyrants,

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Disqualification — A Trap for the Unwary

After years of meetings and seminars, your networking has finally yielded results. You have landed that big client and you are litigating a mega-case. You have spent late nights, long weekends and sacrificed family commitments to impress this client with your commitment to protecting his rights. Then, in an unassuming beige envelope sent by opposing counsel, your nightmare begins. First, you are accused of unethical conduct. Next, opposing counsel demands that you be disqualified from further representing your client in this case to which you have devoted so much time and energy.



Robert Roché

What could possibly merit such a sanction?

It is because you hired a secretary three months ago who was employed by opposing counsel before accepting your offer.

Presumptive Disclosure

If this sounds impossible or improbable, it is not. A recent California Court of Appeal decision upheld an order disqualifying a law firm because it hired a paralegal previously employed by opposing counsel. *In re Complex Asbestos Litigation*, 232 Cal.App.3d 572 (1991). In so holding, the court echoed concerns also voiced in a similar decision, in which Latham & Watkins was disqualified because its attorneys briefly interviewed an expert witness who was employed by the other side. *Shadow Traffic Network v. Superior Court*, 24 Cal.App.4th 1067, 94 Daily Journal DAR 5966, 1994 Cal.App. LEXIS 435 (1994).

These decisions were based on perceived concerns regarding the integrity of the judicial process and the public policy of protecting confidential attorney-client communications. As such, they could be applied broadly to disqualify law firms that employ law clerks, secretaries, investigators or summer associates previously employed by opposing counsel.

Indeed, motions to disqualify counsel have reached epidemic proportions. See *Responsible Citizens v. Superior Court*, 16 Cal.App.4th 1717, 1725 (1993); Comment, *Federal Courts and Attorney Disqualification Motions: A Realistic Approach To Conflicts of Interests* (1987) 62 Wash. L. Rev. 863, 874.

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Disqualification — A Trap for the Unwary

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How do you protect against disqualification mania?

This is a new area of the law, but already one message is clear: Before hiring an employee, obtain written consent from any ex-employer who serves as your opposing counsel.

If written consent cannot be obtained, the only safe course is not to hire the employee. Nevertheless, decisions in other jurisdictions and common sense suggest that it should be possible to hire an applicant if care is taken to insure that no confidential information is conveyed.

This article discusses these principles, the pitfalls, and the procedures to follow in hopes of avoiding disqualification.

The Basic Legal Framework

A trial court's authority to disqualify an attorney derives from its inherent power to control, in furtherance of justice, a judicial proceeding. Code of Civil Procedure § 128(a)(5). Courts also consider the client's right to counsel of his or her choice, an attorney's interest in representing a client, the financial burden on the client of replacing disqualified counsel and any tactical abuse underlying the disqualification proceeding. See *Bell v. 20th Century Ins. Co.*, 212 Cal.App.3d 199, 197-198 (1989); *Gregori v. Bank of America*, 207 Cal.App.3d 291, 300-301 (1989).

With this authority, courts apply the Rules of Professional Conduct, including Rule 3-310(D), which bars an attorney from accepting employment adverse to a client or former client where the attorney has obtained confidential information except with informed written consent. In applying these rules, courts have seized on the notion of confidential information, finding that disqualification can be warranted even where such information is possessed by non-lawyers who happen to be hired by a law firm.

Thus, in *In re Complex Asbestos Litigation*, 232 Cal.App.3d 572 (1991), the court upheld an order disqualifying a law firm from representing plaintiffs in nine asbestos suits because that firm hired a paralegal who had been employed by defendants' counsel (Brobeck, Phleger & Harrison). While employed by Brobeck, Mr. Vogel, the paralegal in question, had access to confidential reports that evaluated the merit of asbestos claims brought by the Harrison firm. Before changing jobs, Mr. Vogel disclosed that he was employed by Brobeck and he specialized in asbestos litigation. He also provided assurances that Brobeck had consented to his new employment; however, those assurances proved useless. Mr. Vogel's new employer failed to obtain Brobeck's written consent and it was disqualified.

The message of this case is clear: Before hiring an employee who works for opposing counsel, obtain written consent from the other side. Otherwise, the ex-employer can obtain disqualification of your firm if it can show that the ex-employee possesses material, confidential attorney client information.

To make this showing, the ex-employer need not disclose material information. It is only necessary to show the nature of the information and its material relationship to the proceeding. See *In re Complex Asbestos Litigation*, *supra*. Once this is shown, a rebuttable presumption arises that the attorney-client information has been used or disclosed to the current employer. See, Cal. Evid. Code §§ 605 and 606.

When You should Be Alert to Potential Problems

There are three critical points. First, when interviewing any new employee, find out if there is a conflict problem. It goes without saying that, once an employee is hired, it may be too late to correct the problem.

Ask if the employee is working on matters related to your practice. Ask what clients the employee represents. Your firm's conflict checking system should include the identities of adverse counsel. Use that system to find out if a prospective law clerk is employed by opposing counsel in any case.

The second, critical point in time is when pleadings are amended to add new parties. A firm's conflict checking system should be consulted when that occurs.

Third, conflicts should be investigated whenever there is a change of opposing counsel.

Prudent Safeguards

Once you determine that a possible conflict exists, screening, if employed effectively, could prevent disqualification. Termed "ethical screens," "cones of silence," "Chinese Walls," or "ethical walls," screening systems involve physical, geographic, and departmental separation of individuals and prohibitions against, and sanctions for, discussing confidential matters with the "tainted" individual. They also consist of established rules and procedures preventing access to confidential information and files and procedures for preventing a "tainted" individual from sharing any confidential attorney-client information he or she may possess.

To be effective, screening must achieve two objectives. First, screening should be implemented before undertaking the challenged representation or hiring the tainted individual. Screening must take place at the outset to prevent disclosure of any confidences. Second, the tainted individual should be precluded from any involvement in, or communication about, the challenged representation.

The goals of screening can be achieved by undertaking the following suggestions: To avoid inadvertent disclosures and establish an evidentiary record, a memorandum should be circulated warning the legal staff to isolate the individual from communications on the matter and to prevent access to the relevant files. 1 *Mallen & Smith, Legal Malpractice*, § 13.19, pp. 794, 795-96 (3d ed. 1989). The memorandum should be distributed to the lawyers and also to the file room staff, informing them that the "tainted" individual should not have access to the relevant files. If feasible, move all relevant files to another suite or store all relevant files behind locked doors thereby precluding any access by the tainted individual. Although this procedure may be excessive or impractical for some small firms, if you have extra floor space or an empty office, it would be a good idea to establish a separate war room with a locking door.

Additional steps which may rebut the presumption of disclosure include declarations from the tainted individual and members of the law firm. These declarations should state that the tainted individual did not possess confidential information or that no confidential information was disclosed and the requirements of screening were rigorously respected and followed.

Bear in mind that the court's determination will likely turn on

the credibility of the declarants. See, *In re Complex Asbestos Litigation*, 232 Cal.App.3d 572, 598; *Shadow Traffic Network, et al. v. Superior Court* (1994) 24 Cal.App.4th 1067. Thus, avoiding disqualification will require strict monitoring of the firm's employees and lawyers as well as the tainted individual.

Special Concerns for Large Firms

Additional issues are presented for attorneys who practice in large, multi-office law firms. First, because the court in *In re Complex Asbestos Litigation* took its approach from cases where an entire firm was subject to vicarious disqualification because one attorney changed sides, that holding may be applied to disqualify multi-office law firms under similar circumstances involving a non-lawyer employee. Conflict checks should be conducted firm-wide and ethical walls created to avoid improper disclosures.

Additionally, a firm's E-Mail practices may undermine attempts to rebut presumptive disclosure. Law firms that communicate through electronic mail invite the unwitting to convey confidential information to a faceless computer at the other end of a data transmission line. Firm procedures should be set up to safeguard against such messages causing chinks in the firm's Chinese Walls.

Special Concerns for Small Firms

Small firms face different obstacles. Due to their size, screening may not seem possible notwithstanding the best intentions. It may be impractical for a small firm to screen a paralegal, who might be the firm's only paralegal, from disclosing or having access to relevant matter.

No reported California opinion addresses the issue of whether a firm was too small to screen a non-lawyer employee who possessed material confidential attorney-client information from his prior employer. Where the employee who has the conflict is an associate, courts in other jurisdictions have held that a firm may be too small to effectively screen an individual and ordered the firm disqualified. See, e.g., *Yaretsky v. Blum*, 525 F.Supp. 24 (S.D.N.D. 1981) (thirty-member law firm disqualified; screening not likely to be effective where "tainted" lawyer was member of health department which was litigating matter with which the "tainted" lawyer had conflict); *In re Asbestos Cases* 514 F.Supp. 914 (E.D. Va. 1981) (five-member law firm disqualified where matter in dispute constituted a large percentage of firm's case load).

In short, small firms may have no choice but to steer clear of individuals who have conflicts irrespective of their talents because screening may not be deemed effective.

Conclusion

Recent cases have sent a clear message that hiring the wrong clerical employee can lead to severe consequences. Given the uncertainty in this evolving area, counsel should obtain advance written consent from a new employee's former employer if a conflict situation exists.

Otherwise, you will proceed at your peril. Although screening measures can be employed, there is no guarantee that a court will view them as sufficient to prevent disqualification.

—Robert Roché

When Your Client Is a Target

The debate over private enforcement of the federal securities laws simmers in Congress, the courts, corporate boardrooms, political action committees, and the Op-Ed pages of the business press. As befits any contentious public debate, the views of the participants are polarized.

On one side, business interests and professionals (investment bankers, accountants and others) claim that the now-common occurrence of the hurriedly-filed securities fraud lawsuit retards efficient capital formation, is a "strike suit," and places unfair liabilities and disincentives on business executives and auditors. These interests are squared off against plaintiffs' class action attorneys and consumer advocates who marshal their own statistics. This contingent is aided in public appearances by widows who lost their life savings because of the Lincoln Savings debacle and assembly-line workers who saw their retirement funds jeopardized by the excesses of the 1980's junk-bond phenomena. Adding to the clamor and contentiousness is the claim that plaintiffs file "boilerplate" complaints that roll off word processors, differing mainly in the names of the defendants. Plaintiffs' attorneys retort that their complaints are particularized statements of corporate wrongdoing uncovered by self-appointed champions of the individual investor.

Picking through the debate, one thing becomes clear. Little is known by defense counsel or the business community about *why* and *under what circumstances* a plaintiffs' securities lawyer files suit against a public company following a stock drop. This article examines some of those considerations.

Getting the Preliminaries Out of the Way — Do I Have a Client and are There Potentially Recoverable Damages?

The two preliminary questions that the plaintiffs' lawyer asks are: First, have I been (or, perhaps, better put "can I be") retained by a client who is a suitable class representative; and, second, are potentially recoverable damages great enough to make this case a wise business risk?

While dismissing the entire process as financial "ambulance chasing" may in certain circles be politically correct, an important consideration for the plaintiffs' attorney is whether the plaintiff is likely to be an "adequate" representative within the meaning of FRCP 23. Individuals who probably would not pass muster include the hapless investor who bought *after* the "bad news" had already leaked into the marketplace, or who purchased an unusually small amount of stock, who did not actually suffer a loss on the stock purchase, or had access to inside information about the subject company. The named plaintiff's status should be considered before a lawsuit is filed because it



Michael A. Sherman

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certainly will be raised during the class certification process.

The other preliminary question is about damages — more specifically, is there a threshold minimum of damages potentially present and recoverable in this case? A rule of thumb typically used is that potentially recoverable damages should be in the range of *at least* 5 to 10 million dollars. That “rule of thumb” is never resolved in a vacuum, however, as many more issues are typically delved into at this preliminary stage, such as:

(a) the subject company's average daily trading volume during the proposed class period (which is a component of most damages analysis);

(b) The magnitude of the price decline (by itself, a drop of a few points may not support a claim of materiality);

(c) whether the volume of “short selling” activity is such that the bad news was arguably known to the marketplace even before the stock drop (short selling is the practice of selling borrowed stock and later buying that stock on the open market and returning it to its owner, with the short seller profiting if the price of the stock declines during the period when the stock has been borrowed);

(d) how the subject company's stock has performed relative to its industry group;

(e) the time over which the company's stock declined in response to the alleged “true facts” coming to light.

This last point is particularly sensitive and subject to differing interpretations, as a case of gradual leakage of truthful information into the marketplace (referred to by plaintiffs' counsel as a “slow leakage case”) may cause a gradual decline in a stock price over a period of weeks or months. In that case, there will unquestionably be controversy over whether (and when) the marketplace “knew” the true facts, whether the incremental information that leaked into the marketplace was “material” within the meaning of the securities laws, and whether plaintiffs' theory of causation (*i.e.*, that the subject company's nondisclosure or misrepresentation caused the artificial inflation in the stock price, and ultimately precipitated the slow decline in stock price) is plausible.

Whether the damages threshold has been met must also be considered in light of the availability of insurance to cover the claims. Simply put, it is a lot more palatable to spend insurance money than to pay out of a company's retained earnings. Consequently, when considering whether to file suit against a small, start-up company with minimal insurance coverage, plaintiffs' attorneys exercise extra caution.

On to the Merits — “Reverse Engineering” the Company's Statements

At the core of the public debate is whether the “merits matter” in the filing of these lawsuits. (*See generally*, Alexander, “Do the Merits Matter? A Study of Settlements in Securities Class Actions,” 43 *Stan.L.Rev.* 497 (1991)). Without attempting to enter that fray, the question that naturally arises is what “merits”?

At the pleading stage, on a motion to dismiss brought under FRCP 12(b)(6), courts typically don't investigate the adequacy of the proposed class representative or analyze damages. Instead, the issue is whether the complaint articulates a sound basis for liability under federal securities laws. Generally, counsel must be concerned with pleading misrepresentations or omis-

sions that are material and facts showing that the defendants had the requisite “scienter.” The latter element is generally expressed in terms of “actual knowledge or recklessness involving an extreme departure from ordinary care.” *In re GlenFed, Inc. Securities Litigation*, 11 F.3d 843, 847 (9th Cir. 1993), *reh'g granted*, 1994 U.S.App.Lexis 3331 (9th Cir. 1994).

Further, the courts may inquire into whether plaintiffs' counsel has properly drawn inferences from the public record about what “may have occurred” or what “must have occurred,” or whether the complaint simply alleges what some courts are prone to describe as “fraud by hindsight.” *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990). The more experienced plaintiffs' counsel will typically address these pleading requirements with great care. They well know that a willing class representative and the prospect of big damages alone cannot add up to a case under the federal securities laws.

The Hot Buttons

What, then, are the “hot buttons” that plaintiffs' counsel searches for?

Start with the company's own statements. Stock declines most frequently follow a negative company announcement or other news item interpreted by the marketplace as portending a negative drag on future profitability. Typically, the company might announce that earnings will fall short of previous forecasts; competitive pressures are adversely impacting profit margins; a company's products are not being well received in the marketplace; a government agency has called into question certain company practices or conduct, or recalled a company product; or a previously-announced merger will not go forward.

Once counsel has zeroed in on the negative announcement, counsel then proceeds to match the “bad news” with earlier public announcements to search for possible inconsistencies between the two. For example, consider a financial institution that just announced large additions to its loan loss reserves. Such an announcement would be inconsistent with the institution's statement only months earlier that its lending practices were “conservative” and its reserves “adequate.” Then there is the case of a drug company buffeted by results of an FDA study critical of the efficacy of a new drug. What if the company had announced just months earlier that the testing of the drug was producing excellent results and FDA approval was expected? Or, consider the defense contractor that announced cancellation of a large government contract resulting from poor performance. What if that contractor had stated a quarter earlier that performance under the contract was proceeding smoothly?

Plaintiffs' counsel proceeds with the search for these inconsistencies while carefully reviewing the company's public statements including audited and unaudited financial statements. Counsel questions whether there is an appearance of “managed earnings,” whether company management has unduly hyped an important product, whether the negative announcement has been accompanied by a financial presentation indicative of “channel stuffing,” or whether the negative announcement is somehow tied in with the exposure of aggressive accounting practices.

To elaborate on these terms:

“*Managing earnings*” is an accounting manipulation whereby expenses and revenues are aggressively shifted around on a quarterly basis to produce a smooth, stepped-up earnings growth over an extended period of time. The accounting manipulations that lead to “managed earnings” are varied, and corporate

restructurings that result in the creation of large accounting reserves are just one signal that plaintiffs' counsel look for.

"Product hype," known to every consumer, may take on critical significance for investors in the marketplace, as exemplified in *Hanon v. Dataproducts Corp.*, 976 F.2d 497 (9th Cir. 1992). There, the court reversed summary judgment in favor of the defendant company, holding that material issues of fact precluded summary judgment as to whether the company misled the market by improperly touting its new product line of computer printers. The Ninth Circuit based its decision on an incriminating statement in the diary of a senior vice president of the company, who had observed that the new line could not be built reliably. *Id.* at 502.

"Channel stuffing" is a form of financial statement legerdemain whereby products are shipped in large volume during the last days of a quarter or year-end, frequently of obsolete inventory and in excess quantities, to captive purchasers (a favorite is the affiliated distributor) in an effort to meet sales targets. See, e.g., Berton, "Numbers Game: How Miniscribe Got Its Auditor's Blessing On Questionable Sales," *Wall St. J.*, May 14, 1992, at A1).

Aggressive accounting practices figure prominently in this analysis, as certain financial statement entries or ratios which significantly vary from industry standards or norms may result in artificially high profits. For example, a company might boost its profits by booking as an asset an abnormally large percentage of capitalized costs (such as software development costs).

Forecasts, Earnings Projections and Analyst Reports. Opinions, earnings forecasts, and even expressions of optimism may under certain circumstances be actionable. *Marx v. Computer Sciences Corporation*, 507 F.2d 485 (9th Cir. 1974). While a public company is under no obligation (except in certain limited instances) to make forecasts, and the failure of a prediction, projection or forecast to come true will not, by itself, render a company liable under the federal securities laws, plaintiffs' attorneys seize upon earnings projections made by senior company executives. For example, they frequently focus on an officer's statement that he "is comfortable" with an analyst's bullish earnings projections, contending that this is the same as if the company had made the earnings projections itself. Plaintiffs' counsel will make generous use of those statements in their complaint if the officer's statement was made a few weeks before the company reported a *quarterly loss*, causing the company's stock to drop 25%!

Similarly, securities analyst reports are routinely scoured in analyzing the merits of a particular action. Although defendants contend a company should not be held responsible for projections by analysts, plaintiffs' attorneys retort that those projections are often expressly based on corporate statements at investment seminars or meetings. In those circumstances, it may be reasonable to infer that the assertedly false or misleading statements were indirectly made by the company.

Searching For Scienter — Insider Trading And Other Stock Transactions. Stock market professionals generally agree that heavy insider selling (frequently referred to by plaintiffs' counsel as "bail-outs") does not augur well for a company's future. Courts, too, frequently view unusually timed, heavy insider selling before a precipitous stock drop as potentially a "badge" of fraud. *Goldman v. Belden*, 754 F.2d 1059 (2nd Cir. 1985). While there is a lag time in the reporting by insiders to the SEC, insider stock transactions are publicly available infor-

mation, and are always looked at carefully by plaintiffs' lawyers in analyzing a case.

Other types of stock transactions may also be fertile ground for plaintiffs' counsel to argue the presence of scienter. In recent months, for example, many companies have initiated stock buyback programs as a way of creating shareholder wealth, particularly in a bear market (see, e.g. *Forbes*, July 4, 1994, "Eating What The Chef Eats," by John Rutledge). However, the combination of a stock buyback program *with* heavy insider selling may be a particularly combustible mixture. Thus, plaintiffs' counsel may attempt to discover whether the corporation was subsidizing the corporate insiders' stock sales by committing corporate capital to a buyback program intended to keep the stock price high during the period of insider selling.

Similarly, the granting and exercise of stock options are scrutinized by plaintiffs' counsel, as there are ever-present opportunities for experienced plaintiffs' counsel to claim self-dealing and abuse, particularly when stock options have been re-priced to make insider stock sales more attractive.

Other "Red Flags." It would be impossible to catalog all conceivable fact patterns and different forms of analysis undertaken by plaintiffs' counsel before filing suit. Admittedly, a series of bullish earnings projections accompanied by heavy insider selling and topped-off with a large dose of irreconcilable statements or admissions may result in the filing of 20 or more "copycat" lawsuits within 48 or 72 hours of the stock drop; yet, the vast majority of cases don't have such egregious facts. In fact, SEC Commissioner J. Carter Beese recently questioned whether the typical earnings projection case should even state a claim for securities fraud. See, "Beese Says Forward-Looking Statements Warrant Business Judgment Rule Analysis," *Corporate Counsel Weekly (BNA)*, Vol. 9, No. 23 at 2 (June 15, 1994).

On occasion, though, disgruntled employees or competitors, or news media reports, bring to light instances of corporate wrongdoing: defense contractor plots to bilk the government; high profile failures in consumer products, such as automobile recalls; "ponzi" or embezzlement schemes that surface, and drive companies into bankruptcy court, etc. In each of those cases, the plaintiffs' securities lawyer checks the market price of the publicly-traded company's securities, and seeks to determine whether the company's prior public statements may have misled the reasonable investor and the marketplace.

Additionally, plaintiffs' attorneys are attentive to the trappings of power in the publicly-held company. They may argue that "extravagances" — a fleet of corporate jets for a regionally-based company, or reports in proxy materials of excessively large expense accounts for senior officers — provide further evidence of scienter.

Avoiding Frivolous Lawsuits

All sides in the debate over private enforcement of the securities laws appear to acknowledge that "frivolous" lawsuits should be distinguished from lawsuits that turn out to be without merit. Rigorous application of a merits evaluation, instead of a reflexive and poorly thought-out decision to file suit, may result in fewer "frivolous" lawsuits.

Finally, another question remains, directed to corporate officers and defense counsel — namely, whether litigation can be avoided or defeated if the warning signs and "red flags" are recognized early on by corporate officers and dealt with responsibly. By so doing, the corporation may lessen its exposure as a "target" in a securities fraud lawsuit.

—Michael A. Sherman

The Thicket of Allocation Under D&O Insurance Policies

Although Directors and Officers Liability and Corporate Indemnification ("D&O") insurance policies have existed for approximately 50 years, only recently, with the explosion of litigation initiated by federal banking regulators, and huge judgments, have courts focused on the scope of coverage provided by D & O insurance.

Problems in policy interpretation have arisen in large part because the D & O policy is completely different from the general liability policy. Often, courts have misunderstood the nature of the D & O policy and applied concepts developed in litigation involving liability and consumer-oriented policies, rather than commercial indemnification policies.

The D & O Policy provides indemnity for the liability of insured directors and officers. It does not insure the corporation itself for its own wrongdoing, even though the disputed conduct may be accomplished through its agents, including its officers and directors. Thus, when litigation involves not only insured parties, but uninsured parties and claims, it is necessary to examine



Constance C. Willems

and apportion liability to determine the amount the insurer must pay.

Unlike most liability insurers, the D & O insurer does not control defense of the underlying litigation. This lack of control creates the need to allocate costs retroactively among insured and uninsured claims and parties. Therein lies the problem.

Relative Exposure Rule

In apportioning liability between insured and uninsured persons, entities and claims, the better reasoned decisions have applied the "relative exposure rule." This approach recognizes that, just because a director or officer is sued together with the uninsured corporation, it does not follow that the entire exposure is transformed into a loss covered by the D & O insurer. Courts applying the relative exposure test allocate litigation and defense costs by determining the relative liability exposure of each defendant in the underlying case, which may depend on their relative culpability.

This approach was adopted by the Ninth Circuit in *Slottow v. American Casualty Co.*, 10 F.3d 1355 (9th Cir. 1993). There, the trial court sanctioned a settlement in which the settling parties apportioned most liability to insured directors and officers. The Ninth Circuit appropriately viewed the allocation with a jaundiced eye and instructed the lower court to determine whether the allocation accurately reflected the respective parties' proportional share of comparative liability.

On remand, the district court reduced the director's liability from 96% to 55% and assigned the remaining 45% to the corporation. *Corporate Officers and Directors Liability Litigation Reporter*, March 16, 1994, at 15275. Subsequently, the court applied the same formula to the allocation of attorneys' fees incurred in the underlying litigation, *Id.*, Apr. 6, 1994, at 15362.

In another recent decision, the California district court in *Safeway Stores v. National Union Fire Ins. Co.*, No. C-88-3440-DLJ, 1993 U.S. Dist. LEXIS 2006 (N.D. Cal. Feb. 4, 1993), concluded that allocation should be based on the relative exposure of the directors and officers as compared with the uninsured defendants in underlying shareholder actions.

The *Safeway Stores* court accepted the parties' formulation of "relative exposure" as the "probable percentage of exposure of each of the defendants, as of the date of settlement, based upon the claims made as to each defendant and other relevant factors." *Id.* at 13. The court adopted the 11-factor test suggested by W. Knepper and D. Bailey in *Liability of Corporate Officers and Directors*, Section 17.06, Supp. at 248-49 (4th ed. 1988 & Supp. 1992), a test that determines "why the parties came up with the particular money settlement that they did." *Id.* at 14-15. Applying these rules, the court ultimately upheld an allocation of 75% to the covered directors and officers and 25% to the corporation. *Safeway, Inc. v. National Union Fire Ins. Co.*, No. C-88-3440-DLJ, 1994 WL 10029 (N.D. Cal. Jan. 5, 1994).

Another recent case applying the relative exposure rule is *First Fidelity Bancorporation v. National Union Fire Ins. Co.*, No. Civ. A. 90-1866, 1994 WL 111363 (E.D. Pa. Mar. 30, 1994). The *First Fidelity* court specifically adopted a line of cases which require allocation when directors and officers are sued together with the corporation.

"The mere fact that liability arises exclusively from the conduct of the insured does not provide a basis for the insurer to be responsible for the liability of those who are uninsured." *Id.* at 12.

The court analyzed the gravamen of the claims asserted by the underlying plaintiffs and observed that Section 11 of the Securities Act of 1933 provides different standards of liability for issuers (*i.e.*, the corporation), who are almost absolutely liable for misstatements made in connection with the sale of securities, as opposed to directors and officers, who are allowed a due diligence defense. Under these circumstances, the corporation could be liable even though the directors and officers might be absolved of liability.

Not only did the *First Fidelity* court reject the derivative liability theory enunciated in *Harbor Ins. Co. v. Continental Bank Corp.* (discussed below), it stated that, even if it were to accept this theory, it would not apply due to "sufficient evidence...that the basis of liability stemmed from the conduct of those not named in the suit [and] that First Fidelity settled the underlying litigation for business reasons rather than on the basis of liability of the directors and officers." *Id.* The *First Fidelity* court saw no reason to disturb the jury's allocation to the directors and officers of \$14.8 million out of a settlement of \$25 million, the remainder to be borne by the corporation.

Recently revised National Union D & O policies expressly require the parties to "use their best efforts to allocate the settlement between the company and the insured." This policy provision played a significant role in the *First Fidelity* decision. However, even the absence of this provision should not have led to a different result, because the need for allocation is implicit. D & O policies specifically state what they do cover, thus eliminating exposure for risks not specifically described in the policies.

Other cases recognizing the duty to allocate based on relative culpability include *H.S. Equities, Inc. v. Hartford Accident & Indem. Co.*, 661 F.2d 264 (2d Cir. 1981) (under New York Law,

settlement of underlying securities and related claims held not conclusive evidence of culpability of defendants so as to bind issuer of blanket brokers bond; court split responsibility 50-50 between insured and uninsured defendants); *Okada v. MGIC Indemnity Corp.*, 823 F.2d 276 (9th Cir. 1986) (insurer's interim funding of defense costs to be allocated based on allegations of complaint); *Harristown Development Corp. v. International Ins. Co.*, No. Civ.A. 87-1380, 1988 WL 123149 (M.D. Pa. Nov. 15, 1988) (insurer entitled to allocate settlement between corporation, a non-covered party, and director based on their relative liability); *Gon v. First State Ins. Co.*, 871 F.2d 863 (9th Cir. 1989) (insurer to advance all defense costs, subject to later reimbursement to insurer based on relative exposure); *Prime Computer, Inc. v. Chubb Corp.*, Civ.A. No. 89-2554-H, 1990 WL 117990 (D. Mass. Jan. 3, 1990) (insurers may allocate costs of settling shareholder securities fraud suit between officers and corporation); *Health-Chem Corp. v. National Union Fire Ins. Co.*, 559 N.Y.S. 2d 435 (N.Y. S.Ct. 1990) (insurer liable only for defense costs of covered defendants, not of corporation or unrelated third parties the corporation had contractually agreed to indemnify); *Reliance Group Holdings, Inc. v. National Union Fire Ins. Co.*, 594 N.Y.S. 2d 20 (N.Y. App. Div. 1993) (100% of settlement costs allocated to corporation); *PepsiCo, Inc. v. Continental Casualty Co.*, 640 F.Supp. 656, 661 (S.D.N.Y. 1986) (holding that uninsured defendants could not 'free-ride' on the D & O insurance policy and that the insured had the burden of proving the covered amount).

The "Larger Settlement" Rule

A few courts have failed to follow the relative exposure rule and instead have fashioned a "larger settlement rule." In applying this rule, courts attempt to approximate the amount of an underlying settlement attributable to conduct of the directors and officers, regardless of the relative liability exposure of the parties.

Courts adopting this rule reason that a corporation can act only through its directors and officers and that if a claim is made, it is ipso facto due to a director's or officer's breach or wrongful act causing damage to the plaintiffs in the underlying suit. According to these courts, as the directors and officers are the culprits, the corporation is merely derivatively liable. Therefore, the uninsured amount of a settlement or judgment would be the portion attributable to the presence of the corporation, uninsured employees, or an unaffiliated third party.

The Seventh Circuit adopted this reasoning in *Harbor Ins. Co. v. Continental Bank Corp.*, 922 F.2d 357 (7th Cir. 1990), finding that liability for all settlement payments could be allocated to the directors and officers and saying, in an oft-quoted passage:

"To allow the insurance companies an allocation between the directors' liability and the corporation's derivative liability for the directors' acts would rob [the corporation] of the insurance protection that it sought and bought."

Id. at 368. The court remanded the case to the district court to determine how much larger the settlement might have been by virtue of the activities, rather than the exposure, of uninsured individuals, allowing an allocation only on that basis. The *Harbor* court's reasoning dissolves the corporation as a legal entity into thin air.

A few other courts have, without much discussion, accepted the insured's argument that a corporation can only act through its directors and officers and therefore, all exposure should be

allocated to them and not to the corporation. This result completely ignores the fact that the corporation is a legal person in its own right.

Thus, the reasoning expressed in *Harbor* was adopted in *Raychem Corp. v. Federal Insurance Co.*, No. C-91-20850-RMW, 1994 WL 236557 (N.D. Cal. May 4, 1994). Although *Slottow*, a Ninth Circuit case, should have governed the California district court, Judge Whyte's decision in *Raychem* erroneously concluded that *Slottow* was not applicable. This conclusion was based on the notion that *Slottow* "did no more than overturn the trial judge's factual finding that the defendants' self allocation among themselves...was a good faith settlement...." *Id.* at 12. Judge Whyte then proceeded to adopt the Seventh Circuit's "enlarged settlement" rule rather than the "relative culpability" rule of *Slottow*.

Judge Whyte's opinion is flawed in at least two respects. The controversy in *Slottow* was not a dispute between a corporate officer and the corporation, but between the corporation and the D & O insurer, and the opinion discussed the relative culpability of the director and the corporation in that context. Secondly, as the reasoning of *Harbor* is flawed, so is Judge Whyte's decision. *Raychem* should have adopted *Slottow*'s reasoning, rather than that of another circuit, particularly since the Ninth Circuit previously held, in *Okada* and *Gon*, that defense costs should be allocated based on relative exposure.

A Modest Proposal...

Thus, the Ninth Circuit has adopted the relative exposure rule, while the Seventh Circuit seems to have opted for the larger settlement rule. The Seventh Circuit has found few followers. Indeed, its *Harbor* decision is against the weight of authority. It is submitted that the better course is to analyze the scope of relative culpability and the responsibility of the directors and officers for the alleged exposure.

One case provides a reasoned framework for this analysis, *Perini Corp. v. National Union Fire Ins. Co.*, No. 86-3522-5, 1988 U.S. Dist. LEXIS 17442 (D. Mass. June 2, 1988). There, the court correctly concluded that coverage under a D & O policy extended only to claims brought against the insured directors and officers, and the corporation itself was not insured under the terms of the policy. Noting the paucity of case law on the question of allocating legal fees under D & O policies, the court adopted a four-prong test:

- a) Are the claims directed principally against the corporation (*e.g.*, breach of contract) or do they focus on officer/director wrongdoing (*e.g.*, breach of fiduciary duty)?
- b) How many claims in the complaint are asserted against each defendant?
- c) What percentage of the total number of defendants are directors and officers?
- d) Which defendants will derive primary benefit from the resolution of the action?

Id. at 5-6. Though providing a fair, equitable, and realistic analysis of allocation issues, the test set forth in *Perini* has not often been applied in practice.

It seems that most problems arise because of the courts' failure to analyze the circumstances under which a director or officer could be held personally liable to a third party. Since a

(Continued on page 8)

corporation has to act through its agents, liability arising from acts performed in the ordinary course and scope of the director's and officer's responsibilities in the interest of the corporation should rightfully be the corporation's. In many cases, however, the courts focus solely on the acts of the director or officer, not on those of the corporation or of other uninsured parties.

A number of courts have recognized the differing degrees of exposure for the corporation and its agents. See, e.g., *Olympic Club v. Underwriters at Lloyds London*, 991 F.2d 497 (9th Cir. 1993) (suit against private club for discriminatory policies not covered by D & O policy because suit was based on club's own policies and not on actions of officers and directors); *First Fidelity Bank Corp. v. National Union Fire Ins. Co.*, 1994 WL 111363 (E.D. Pa. Mar. 30, 1994) (court considered whether insured settled based on business reasons or based on exposure of corporation or directors and officers); *Ameriwood Industries Int'l Corp. v. American Casualty Co.*, 840 F.Supp. 1143 (W.D. Mich. 1993) (allocation of defense costs must consider portion attributable to corporate liability as opposed to liability of individual officers and directors, portion attributable to covered versus uncovered claims, and portion of corporation's liability that is derivative of directors' and officers' liability); *Scottsdale Ins. Co. v. Homestead Land Development Corp.*, No. C-90-3144-SBA (WDB), 1992 WL 453356 at 6 (N.D. Cal. Dec. 3, 1992) (allocation under comprehensive liability policy: "[I]t would be patently unreasonable to expect an insurer to protect its insured against liabilities for which the insured did not bargain. Any conclusion to the contrary would lead to a windfall for the insured."); *Olsen v. Federal Ins. Co.*, 268 Cal.Rptr. 90 (Cal.App.2d Dist. 1990) (no recovery of attorneys' fees under D & O policy as no "wrongful acts" alleged against director, while other acts were alleged in capacity of shareholder rather than director). These cases and principles seem well suited to analyzing the multiple issues involved in making an equitable allocation, thus providing the full benefits for which the insured bargained without distorting the scope of the insurer's risk.

—Constance Charles Willems

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Attorneys

In *General Dynamics Corp. v. Superior Court (Rose)*, 94 Daily Journal D.A.R. 10068 (July 18, 1994), the state Supreme Court held that an in-house attorney could pursue implied-in-fact and retaliatory discharge causes of action against his employer. The court concluded that:

"There is no reason inherent in the nature of an attorney's role as in-house counsel to a corporation that in itself precludes the maintenance of a retaliatory discharge claim, provided it can be established without breaching the attorney-client privilege or unduly endangering the values lying at the heart of the professional relationship."

Id. [emphasis in original]. In so holding, the Court rejected General Dynamic's contention that it had an unfettered right to discharge an attorney at any time under *Fracasse v. Brent*, 6 Cal.3d 748 (1972).

Securities Fraud Class Action

In *Welling v. Alexy*, 94 Daily Journal D.A.R. 10086 (N.D. Cal. June 20, 1994), the court held that a sophisticated trader who executed numerous transactions, including the purchase and sale of call options, could act as class representative. The court also certified a plaintiff who continued to hold stock at the end of the class period, rejecting contentions that his interests were at odds with those of plaintiffs who sold all of their stock. At the same time, the court held that a "professional plaintiff" who had participated in 14 separate securities class action lawsuits was not eligible to serve as a class representative.

Wrongful Termination

The California Supreme Court sharply limited the doctrine of constructive discharge, making it more difficult for employees to recover for wrongful termination on the theory that they were forced to quit. *Turner v. Anheuser Busch*, 7 Cal. 4th 1238, 94 Daily Journal DAR 10373 (July 25, 1994). The plaintiff quit his job after he received a negative performance evaluation and then filed an action for wrongful termination. The Court held that the employee did not have a cause of action, holding that, a plaintiff must:

"plead and prove, by the usual preponderance of the evidence standard, that the employer either intentionally created or knowingly permitted working conditions that were so intolerable or aggravated at the time of the employee's resignation that a reasonable employer would realize that a reasonable person in the employee's position would be compelled to resign."

The Court specifically stated that a "poor performance rating or a demotion, even when accompanied by reduction in pay, does not by itself trigger a constructive discharge."

Insurance

The Ninth Circuit ruled that an insurance agent's representations regarding coverage did not create coverage without a showing of detrimental reliance through proof that the insured could have purchased the disputed coverage from another insurance company. Thus, the insurer was not required to provide coverage for a lawsuit asserting fraud and bad faith against a bank and its officers and directors even though an insurance agent had represented that the subject insurance policy provided coverage for such suits. *St. Paul Fire & Marine Ins. Co. v. American Bank*, 94 Daily Journal D.A.R. 12246 (Aug. 31, 1994). The district court had ruled that St. Paul was estopped to deny coverage because the bank detrimentally relied on the agent's representations. The Ninth Circuit reversed, finding an

absence of detrimental reliance necessary for estoppel because the insured failed to prove that he could have purchased the disputed coverage from any insurer.

Attorneys' Fees

On remand from the U.S. Supreme Court, the Ninth Circuit held that a party bringing a cost recovery action under the Comprehensive Environmental Response Compensation and Liability Act (CERCLA) can recover attorneys fees incurred to locate other potentially responsible parties. *Key Tronic Corp. v. United States*, 94 Daily Journal D.A.R. 10167 (9th Cir. July 21, 1994).

Attorney Malpractice

Adding to the confusing mixture of cases addressing accrual in attorney malpractice case, the First Appellate District held that such an action accrues when a missed statute becomes an issue in the underlying litigation. *Adams v. Paul*, 94 Daily Journal D.A.R. 9761 (Court of Appeal July 8, 1994). The court rejected the rule that an action accrues when an adverse judgment is entered.

Accountant Liability

In *APSB Bancorp v. Thornton Grant*, 26 Cal. App. 4th 926, 94 Daily Journal D.A.R. 9758 (Court of Appeal, July 11, 1994) the Second Appellate District held that an independent auditor could not seek mandatory indemnification under Corporations Code § 317 as a corporate agent of the bank that retained it. The court held that the auditor was not the bank's agent because the auditor and the bank were engaged in separate occupations, the work performed by the auditor was not part of the bank's regular business and the auditor's engagement letter did not expressly create an agency relationship.

Insurance

In *Rockwell International Corporation v. Superior Court*, 26 Cal. App. 4th 1255, 94 Daily Journal D.A.R. 10151 (Court of Appeal July 20, 1994), the court held that the standard cooperation clause included in third-party liability insurance policies does not operate as a contractual waiver of the insured's attorney-client privilege in the event of coverage litigation between the insured and its insurer.

Real Property

The Marketable Record Title Act, Civil Code § 880.020, limits a lien on a deed of trust to 10 years after the maturity date of the obligation if the date is ascertainable from the record. In *Miller v. Provost*, 26 Cal. App. 4th 1703, 94 Daily Journal D.A.R. 10493 (Court of Appeal July 25, 1994), the Court of Appeal construed the meaning of the phrase "ascertainable from the record" and held that the holders of a deed of trust have the right to exercise the private power of sale granted in the deed of trust after expiration of the ten-year period where the promissory note is not recorded or the deed of trust is silent as to the payment date for the obligation.

Insurance

In *Camelot by the Bay Condominium Homeowners Assoc. v. Scottsdale Ins.*, 27 Cal. App. 4th 33, 94 Daily Journal D.A.R. 10619, the Court of Appeal held that an insurer did not breach the implied covenant of good faith and fair dealing for failing to settle within policy limits where there was no danger of excess liability to the insured for third party covered claims. It determined that the trial court erred in holding that the insurer was

required to settle the action to cap its insured's potential loss for both covered and noncovered claims.

Arbitration

The Court of Appeal continued a trend of liberal enforcement of contractual arbitration provisions. In *Slaughter v. Bencomo Roofing Co.* (Court of Appeal June 6, 1994), 25 Cal. App. 4th 744, 94 Daily Journal D.A.R. 7782, the court held that subcontractors were compelled to arbitrate disputes with the general contractor where the subcontracts incorporated by reference all of the terms of the construction contract, including its arbitration provision. The court also held that the owner's disputes with the general contractor and the general contractor's disputes with the subcontractors must be arbitrated in one consolidated proceeding. In *Valsan Partners Limited Partnership v. Calcor Space Facility, Inc.*, 94 Daily Journal D.A.R. 7806 (Court of Appeal June 7, 1994), the Court of Appeal held that any doubts as to the meaning or extent of an arbitration award are for the arbitrators and not the courts to resolve.

Indemnity

Express indemnity provisions may limit a party's right to equitable indemnity. In *Regional Steel Corporation v. Superior Court*, 25 Cal. App. 4th 525, 94 Daily Journal D.A.R. 7600 (May 5, 1994), the Court of Appeal held that an express indemnity clause that provided for indemnity for damage caused in whole by any negligent act or omission of the indemnitor's agent precluded joint tortfeasor liability and, therefore, a claim for equitable or comparative indemnity.



Denise Parga

Civil Procedure

The court of appeal held that a corporation's designation of its principal business office in its annual domestic stock corporation statement conclusively established its principal place of business for purposes of venue under Code of Civil Procedure § 395.5. *Rosas v. Superior Court*, 25 Cal. App. 4th 671, 94 Daily Journal D.A.R. 7606 (Court of Appeal, June 3, 1994).

Torts

In *Bernson v. Browning-Ferris Industries of California, Inc.*, 25 Cal. App. 4th 926, 94 Daily Journal D.A.R. 7713 (June 6, 1994), the California Supreme Court held that a defendant who intentionally conceals its identity from the plaintiff may be equitably estopped from asserting the statute of limitations as a bar to an untimely action where, as a result of the defendant's intentional concealment, the plaintiff is unable to discover the defendant's true identity through the exercise of reasonable diligence. The Court expressly did not address the issue of whether a tort claim accrues only when the identity of the defendant is discovered.

Attorneys' Fees

In *Otis Elevator Co. v. Toda Construction Co. of California*, 27 Cal. App. 4th 559, 94 Daily Journal D.A.R. 10879 (Court of Appeal Aug. 1, 1994), the Court held that Civil Code section 2778(3) does not permit the recovery of attorneys' fees incurred in the prosecution of an indemnification claim unless the contract provides otherwise.

—Denise Parga and Vivian R. Bloomberg

GlenFed versus Wells Fargo — Stirring the Controversy

Are the *GlenFed* and *Wells Fargo* decisions in as much conflict as many practitioners and commentators contend?

Not in our view.

Indeed, these twin Ninth Circuit decisions, *In re Wells Fargo Securities Litigation*, 12 F.3d 922 (9th Cir. 1993), and *In re GlenFed Securities Litigation*, 11 F.3d 843 (9th Cir. 1993), can be read as imparting a single, consistent message — that complaints for securities fraud can and should be dismissed when

they fail to plead fraud with the specificity required under Rule 9(b) of the Federal Rules of Civil Procedure. Moreover, together with recent district court cases and decisions from other circuits, they provide a road map for evaluating when a securities fraud case is vulnerable to dismissal, and how to draft a complaint to minimize the risk of dismissal.

In particular, the cases suggest that dismissal will be warranted if a complaint fails to allege specific fraudulent misstatements, together with facts that can give rise to an inference of fraud. Moreover, as discussed



Vivian R. Bloomberg

further below, the modern trend suggests that a defendant can rarely be held liable for statements or projections by analysts, vague expressions of optimism, accurate statements of a company's past performance, forward looking statements of opinion related to a company's long-term prospects, or statements of opinion that were believed when they were made.

The twin Ninth Circuit decisions arose from similar facts. Both cases involved allegations that financial institutions failed to disclose inadequate loan loss reserves. In *GlenFed*, the court upheld a dismissal order, reasoning that such allegations might constitute mismanagement, but were not adequate to state a claim for securities fraud. In *Wells Fargo*, involving similar allegations, but somewhat more specific information regarding the subject loans, a dismissal order was reversed.

The Ninth Circuit voted to conduct an *en banc* rehearing in *GlenFed*, which went forward on April 21, 1994. Presumably, the Court will issue a decision that will clarify the law in this area. Meanwhile, neither decision has been withdrawn from publication so they continue to stand as valid authority to help litigators identify cases that should be susceptible to dismissal in the early stages of litigation.

In *GlenFed*, plaintiffs alleged that defendants concealed deficiencies regarding *GlenFed's* credit procedures, and inadequate loan loss reserves, and that defendants delayed reporting losses from the corporation's subsidiary. The court in *GlenFed* affirmed well-established principles in the Ninth Circuit by ruling that the complaint should be dismissed because it simply alleged faulty management practices, not false statements made with the "scienter" required for liability under federal securities laws. In so holding, the court criticized the complaint for containing the usual recitation of facts contained in public documents, saying:

"Plaintiffs' complaint is largely an extended comparison between SEC filings and press releases and routine internal cor-

respondence about *GlenFed's* problems and proposed corrective action (management's normal function). By virtue of reliance on public information, Plaintiffs are able to plead the time, place, content, and sometimes a specific author of the alleged misrepresentation, but they have not pled sufficient facts warranting an inference of securities fraud. [Citations.] At best, the allegations reflect the benefit of hindsight and perhaps corporate mismanagement or negligence."

In short, the complaint alleged statements and unfortunate management decisions — but it did not contain allegations that constituted securities fraud. There were no allegations of fraudulent omissions in the face of a duty to disclose, nor of affirmative misstatements that were not believed when they were made.

A different result was reached in *Wells Fargo* because it involved a different complaint. There, plaintiffs alleged specific fraudulent omissions and factual misstatements. (*Wells Fargo*, 12 F.3d at 926, 920).

Consistent with *GlenFed*, the *Wells Fargo* panel held that it was necessary for the shareholder plaintiffs to identify an actionable omission of material fact. (*Wells Fargo*, 12 F.3d at 926.) The court held that the plaintiffs met this burden by alleging a deliberate failure to disclose certain problem loans that promised to have a material impact on *Wells Fargo's* balance sheet. (*Id.*) Thus, the court said:

"[T]his is neither a case of second-guessing decisions by management nor one alleging 'fraud by hindsight', rather, the shareholders have specifically identified facts omitted by *Wells Fargo*, which if subsequently determined to be material, and issued by *Wells Fargo* with the requisite scienter, will establish a violation of §10(b) and rule 10b-5."

Additionally, *Wells Fargo* adhered to established precedent by ruling that an action for securities fraud could be based on affirmative misstatements that were not believed. The court pointed to two misstatements: (1) the company believed certain loans were substantially secured by the borrower's assets, and (2) the company considered loan loss reserved of \$885.4 million to be adequate. The court did not state that these allegations would necessarily give rise to liability, but only that the complaint could withstand a motion to dismiss because these allegations could not be dismissed as immaterial as a matter of law. (*Wells Fargo*, 12 F.3d at 930.) The court went on to explain that defendants might well prevail on a motion for summary judgment, saying:

"[T]he shareholders have stated a claim under § 10(b) and Rule 10b-5. While it may well turn out, as *Wells Fargo* maintains, that the contested statements are neither material nor misleading when considered in context, that is a determination better made on the kind of record which a motion for summary judgment affords." (*Id.*)

Wells Fargo and *GlenFed* may be viewed as decisions marking a boundary between allegations that are sufficient to state a claim for securities fraud and allegations that are not. The two cases both followed established principles in reaching different conclusions.

In *Wells Fargo*, the panel's conclusion was not unanimous, perhaps bearing testimony to the fact that reasonable minds can differ. Indeed, the decision inspired an impassioned dissent by Circuit Judge Stephen S. Trott:

"In the argot of today, a complaint should be dismissed if, read as a whole, it creates a strong impression that, on a report of bad news from the defendant, 'plaintiffs' counsel simply stepped to the nearest computer console, conducted a global NEXIS search, pressed the 'Print' button, and filed the product as their complaint.' [Citation.] Here, plaintiffs cite annual reports, quarterly reports, banking regulations and newspaper articles. They list customers of the Bank who are known today to be burdened with debt. But nowhere does the complaint link the facts stated to a coherent theory of securities fraud."

District courts are now confronted with the difficult task of

navigating the seemingly narrow channel marked out by *GlenFed* and the majority and dissenting opinions in *Wells Fargo*. It appears that the courts are meeting that challenge by dismissing inadequate complaints, as in *Adam v. Silicon Valley Bancshares*, Case No. C 93-20399 RMW (EAD), 1994 U.S. Dist. LEXIS 2797 (N.D. Cal. Feb. 8, 1994). There, the court held that a complaint against an accounting firm, Deloitte & Touche, did not contain sufficiently detailed allegations specifying how the defendant had violated accounting standards and procedures.

Similarly, the complaint was dismissed with prejudice in *In re Caere Corporate Securities Litigation*, 1993 U.S. Dist. LEXIS 16513 (N.D. Cal., Nov. 18, 1993). In that case, decided after *GlenFed* and before *Wells Fargo*, the court reasoned that securities fraud cases are justifiably subject to a heightened pleading requirement for several reasons, including the need to discourage claims designed only to harass defendants or extort settlements.

There, plaintiffs alleged that defendants misled the market by making overly optimistic statements regarding the company's revenues and earnings prospects in press releases and other documents. The allegedly misleading statements included remarks that the company was "well positioned," that 1992 had been an "exciting year," and defendants expected "continuing strong sales."

The *Caere Corporate Securities Litigation* court concluded that the alleged misstatements were not actionable for three reasons. First, some statements were too vague to constitute actionable fraud. Second, some related only to past events. Such statements are not actionable because they contain no implicit prediction that similar events or conditions will continue in the future. Third, the few statements that were forward looking concerned long-term prospects. Even if the defendants had negative information regarding the company's prospects for the immediate future, they still could have reasonably believed that the company's long-term prospects were good. Further, the court held that liability could not arise from forecasts by securities analysts absent allegations that the defendants adopted the forecasts, or knew that the forecasts were unreasonable at the time, but failed to disclose their unreasonableness to investors.

Such recent decisions suggest that a securities fraud case may be susceptible to a motion to dismiss if it is based on the usual allegations that defendants, or securities analysts, made overly optimistic statements shortly before a company's stock price fell. Specifically, the cases suggest that:

- There can be no liability for statements or projections by analysts unless the plaintiffs plead specific facts demonstrating that the defendant has become so entangled with the analyst's forecast that they are attributable to the defendant. *Caere*, citing *In re Verifone Securities Litigation*, 784 F. Supp. 1471, 1486-87 (N.D. Cal. 1992).
- Optimistic statements are not actionable if they are vague. *Caere*, citing *Rogal v. Costello*, [1992-93] Fed. Sec. L. Rep. (CCH) ¶97,245, at 95,093-94 (N.D. Cal. Oct. 8, 1992) (representation by management that "indicated a more positive outlook for the June quarter" and that there was an "apparent upswing" in the buying intentions of U.S. customers too vague to be actionable).
- Accurate statements of past events are generally not actionable because they contain no implicit prediction that past events or circumstances will continue in the future. *Caere*, citing *In re Convergent Technology Sec. Litig.*, 948 F.2d 507, 513 (9th Cir. 1991).
- Forward looking statements of opinion are not actionable if they are related to a company's long-term prospects because a defendant could genuinely have believed that a company's

long-term prospects were good, despite short-term developments. *Caere*, citing *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1113 (9th Cir. 1989), and dismissing claims based on optimistic statements without leave to amend.

- Generally, statements of opinion cannot give rise to liability for securities fraud unless the individual making the statements did not actually hold the favorable opinion when the statement was made, or the favorable opinion had no basis in fact. *In re Apple Computer Sec. Litig.*, 886 F.2d 1109 (9th Cir. 1989).
- A duty to update an optimistic prediction arises only if the original statement included a "definite positive projection" such as, for example, a statement that a deal would be struck by a certain date, or that it would be struck at all. If the original statement was to the effect that the corporation was pursuing a specific business goal pursuant to an intended approach for reaching it, then there may be a duty to disclose any other approaches to reaching the same goal if they are under active and serious consideration. *In re Time Warner Inc. Securities Litigation*, 9 F.3d 259 (2d Cir. Nov. 20, 1993).
- The corporation is not responsible for statements by newspapers and analysts attributed to anonymous corporate "spokespersons," unless (1) the source was an official press release, (2) the statements were attributed to named individuals, or (3) the company placed its "imprimatur" on the third-party report. *Id.*, citing *Alfus v. Pyramid Technology Corp.*, 764 F.Supp. 598, 603 (N.D. Cal. 1991).

By considering such issues at the outset of the litigation, it may be possible to obtain dismissal in the early stages, before your client has endured the time and expense associated with defending costly securities fraud litigation.

—Vivian R. Bloomberg

ABTL's 21st Annual Seminar Set for Hawaii October 21-25

Register now for ABTL's annual seminar, before it sells out. It is set for Friday, October 21 through Tuesday, October 25, 1994 at the Four Seasons Resort in the Wailea area of Maui. Justice Anthony Kennedy of the U.S. Supreme Court will make a special presentation, as will Chief Justice Malcom Lucas of the California Supreme Court. They will be joined on the program faculty by more than 20 state and federal judges from California, and distinguished practitioners.

The topic for the seminar is "Lawyers Liability in the 1990's," and it will feature a mock legal malpractice trial in which leading California trial lawyers will cross swords. Participants will receive 12 hours of MCLE credit, in hard-to-get subjects, including eight hours in Ethics and one hour each in Substance Abuse and Bias Detection and Prevention.

For information, please contact Chrystal Council at (310)839-3954, Rebecca Lee at (310)312-8080, or Joy Gonzalez at (310)371-8409.

Letter from the President

Continued from page 1

dictators, and other totalitarian "governments" do not need lawyers. The solution to problems in societies that are not free is swift, efficient, and delivered at the end of a gun.

That is the point, now turned on its head by detractors of our profession, of Shakespeare's famous line in Henry VI delivered by one of many conspirators planning their ascent to power and the elimination of the freedom of their countrymen. "The first thing we do, let's kill all the lawyers."

The planning committee for this year's ABTL Annual Seminar selected lawyer liability as this year's topic and Shakespeare's point as this year's theme. Lawyer liability is no longer confined to malpractice. In recent years, private parties, governmental agencies, and other organizations have targeted the lawyer as the *other* defendant in a variety of situations employing a variety of theories which blur the line between the role of the lawyer and his or her client.

There was, for example, the celebrated case of *FDIC v. O'Melveny & Myers*, 969 F.2d 744 (9th Cir. 1992), holding that attorneys could be held liable for failing to discover and disclose their client's fraud. Although recently reversed by the U.S. Supreme Court, that case presented the chilling possibility that attorneys might be required to police rather than counsel their clients.

Joining the lawyer as a defendant in the dispute may be the correct thing to do in certain circumstances. However, doing so in the wrong circumstance or for the wrong reason or in the wrong forum carries with it important, and perhaps destructive, consequences for the role lawyers play in our judicial system. The lawyer's obligations to provide confidential advice, to zealously advocate for, and to act as a fiduciary to his or her client are but a few of the essential components of the lawyer's role implicated by new theories of lawyer liability.

We need to be mindful of the implications of theories of lawyer liability that transcend the lawyer or law firm involved in a particular case. A lawyer is not just another potential defendant. Lawyers are officers of the court. They are an essential part of the judicial system that also employs judges and juries to solve problems. While always accountable for their acts, and held to the highest standards, lawyers, like judges and juries, should not be pulled into the dispute simply because they represent another deep pocket or in someone's view did their job too well or not well enough. These are the types of issues we will be discussing at our annual meeting. I hope you will join us and add to the discussion.

This coming year the ABTL celebrates its twenty-first anniversary. For twenty-one years the lawyers and judges of ABTL have, as an organization, shared their time and energy, making our profession better — better educated, better acquainted with one another, better equipped to service our clients and our nation.

I am proud to be a part of our noble profession and privileged to be our organization's president this year. I look forward to working with you to advance the impressive history of ABTL in 1995.

—William E. Wegner

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