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SEC Examinations and Enforcement in the Post-Madoff Era

The SEC's Inspector General's Report Harshly Details the SEC's Failure to Uncover the Madoff Scheme, Offers Road Map to Future Enforcement Policies

BY GREGORY S. BRUCH & JULIE A. SMITH

Gregory S. Bruch is a partner, and Julie A. Smith is of counsel, in the Washington D.C. office of Willkie Farr & Gallagher LLP. Both are former SEC Enforcement attorneys. Contact: GBruch@willkie.com or jasmith@willkie.com.

On August 31, the Inspector General of the Securities and Exchange Commission, H. David Kotz, released a long-awaited report on the Bernard Madoff affair. The report's title, *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme*,[1] accurately describes the 457 pages that convey in painful detail where the SEC staff went wrong in failing to find the world's largest Ponzi scheme. Even if that scheme is measured by only the estimated $12 billion to $20 billion actually invested, rather than the $65 billion perceived by investors who thought their investment gains were real, the Madoff Ponzi scheme was

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From the EDITORS

Are Wall Street & Corporate America Suffering from a Lack of Respect?

Maybe we should have seen it coming earlier this month when the board of American International Group rebuffed a request by Robert Benmosche, AIG's new CEO, to be allowed to use the company's private jet for personal reasons.

Or maybe it was new Supreme Court Justice Sonia Sotomayor's comment, coming in her first Supreme Court appearance, that she thinks—just maybe—the Court should reexamine the 19th Century rulings that conferred on corporations the same rights as people. Commenting that it was judges who "created corporations as persons, gave birth to corporations as persons," Sotomayor said that "[t]here could be an argument made that that was the court's error to start with… [imbuing] a creature of state law with human characteristics."

Of course, this less-than-laudatory language was kicked off earlier by President Barack Obama, who spoke about the need for financial industry regulatory reform at the Federal Hall in New York City on Sept. 14—one year after the failure of Lehman Brothers accelerated a meltdown in the financial sector. The President took the opportunity to remind Wall Street that, yes, the immediate, pulse-pounding portion of the economic crisis may have passed—maybe—but that the U.S. economy is hardly out of the woods and Wall Street is hardly out of the woodshed.

"While full recovery of the financial system will take a great deal more time and work, the growing stability resulting from [government] interventions means we're beginning to return to normalcy," Pres. Obama said. "But here's what I want to emphasize today: Normalcy cannot lead to complacency."

Indeed, the President said he would not heed calls to back off on regulation by "some in the financial industry who are misreading this moment" and strongly expressed his determination that overarching regulatory reform would come to pass.

"So I want everybody here to hear my words: We will not go back to the days of reckless behavior and unchecked excess that was at the heart of this crisis, where too many were motivated only by the appetite for quick kills and bloated bonuses" Pres. Obama told the crowd. "Those on Wall Street cannot resume taking risks without regard for consequences, and expect that next time, American taxpayers will be there to break their fall."

Ouch.

Whatever the comments by Pres. Obama or Justice Sotomayor come to mean in the long run, they certainly added to the feeling that there is something in the air—something that smells like the fun times are definitely over, perhaps for good. Indeed, several areas—most notably executive compensation, hedge funds, credit rating agencies and securitization accounting—all came under the microscope this month. Worse yet for Wall Street is that regulators of all stripes are starting to give strong indications that the previous way of doing business in these areas, like Mr. Benmosche, is not going to fly anymore.

In this issue… The October issue of *Securities Litigation Report* features an analysis by authors Gregory S. Bruch and Julia A. Smith of Willkie Farr & Gallagher LLP of the recent report by the SEC's Inspector General on how the agency handled—or *mis*handled—the Bernie Madoff affair. As the authors describe, the SEC's IG H. David Kotz spared few in the SEC from blame in failing to uncover and stop what became history's largest financial fraud. The authors also outline where the SEC may go with future enforcement policies and what impact those may have on companies.

—JOSEPH M. MCLAUGHLIN & GREGG WIRTH

CONTINUED FROM PAGE 1

one of the largest and longest-running investment frauds ever conducted in this country—one that, if the Inspector General is to be believed—was hidden in plain sight from the SEC staff.

Madoff's crimes will continue to damage the lives of his thousands of victims many years into the future, and it will take years of work from courts, examiners, lawyers and forensic accountants to sort out liability among the remaining solvent parties. The responsibility for the Madoff disaster clearly must be shared by regulators, law enforcement officers, investment professionals, accountants, and the credulous investors themselves. The SEC Inspector General's report looks at only a small piece of the broader question, the conduct of the SEC staff, but does so with an exceedingly keen and unsympathetic lens.

The Madoff affair has already had a profound impact on the SEC and upon its staff. The agency is wounded in the eyes of the investing public and Congress. The hard-hitting report of the Inspector General will inform his future recommendations on staff policies and procedures, and surely will lead to further Congressional inquiry and finger-pointing. This article explores some of the ways that counsel's practice before the SEC, and the culture of the agency itself, are likely to change in the coming months.

The Madoff Scheme

Bernard Madoff was a long-time securities industry insider, and, as it turns out, one of history's great financial criminals. After nearly 50 years of publicly running Madoff Securities, a well-known and registered broker-dealer and market maker, Madoff served on industry boards, advised regulators, and at one point served as the chairman of the NASDAQ, chairman of the board of directors for the National Association of Securities Dealers and as a board member of the Securities Industry Association.

For at least the past 20 years, Madoff was also in charge of an asset management business that purported to invest money for wealthy investors. During most of that time the investment adviser for the asset management business was not registered with the Commission. Many of Madoff's investors appear to have come to him through personal referrals and overlapping social connections. Madoff took money from friends and family alike, and disproportionately from scores of individual Jewish investors, and from a number of prominent Jewish-affiliated charities and non-profit organizations.

See Sidebar—the statement by Senate Banking Committee Chairman Chris Dodd at the Committee's hearing on the report issued by the SEC's IG, on page 9.

On December 10, 2008, Madoff admitted to his sons, who worked alongside their father in the broker-dealer business, that his asset management business was a fraud. The supposed split-strike options strategy he said he used, which supposedly provided positive returns in good times and in bad, was an illusion. In fact, Madoff for many years had been running an elaborate Ponzi scheme, paying returns to earlier investors from the funds of later investors.

The sons turned their father in to the authorities the next day, and he was promptly sued by the SEC and indicted by the US Attorney for the Southern District of New York. On March 12, 2009, Madoff pleaded guilty to 11 felony counts, and was subsequently barred from the securities industry by the SEC. On June 29, Judge Dennis Chin barred Madoff from society at large, sentencing the 70-year-old defendant to 150 years in federal prison.

The Inspector General's Report

The Inspector General's internal investigation began less than a week following the Madoff revelations in December 2009, and it appears to have been exhaustive. Document holds were given to the entire agency, thousands of emails and electronic documents were restored and searched, and all current and former staff involved in the case were interviewed. In total, the Inspector General interviewed 122 people, assisted by outside forensic and subject matter experts.

The Inspector General's findings were troubling, to say the least. Over a period of 16 years, beginning in June 1992, the SEC received six substantive complaints concerning Madoff's investment

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adviser operations, and was aware of two articles in reputable publications questioning Madoff's unusually consistent investment returns. The SEC staff conducted two investigations and three examinations related to Madoff's investment adviser business based upon complaints suggesting that he was running a Ponzi scheme, and failed to detect that he was doing just that.

The report criticizes the SEC staff in blunt terms: "[D]espite numerous credible and detailed complaints, the SEC never properly examined or investigated Madoff's trading and never took the necessary, but basic, steps to determine if Madoff was operating a Ponzi scheme. Had these efforts been made with appropriate follow-up at any time beginning in June of 1992 until December 2008, the SEC could have uncovered the Ponzi scheme well before Madoff confessed."[2]

The Inspector General looked for evidence of corruption in the form of undue influence or improper relationships on the part of the SEC staff, but found none. His adverse findings regarding the SEC staff's technical and managerial abilities are, however, numerous and hard-hitting. They can be grouped roughly as follows:

- ***Expertise***: The Inspector General repeatedly criticizes both the examination staff (from the SEC's Office of Compliance Inspections and Examinations or OCIE) and the enforcement staff. The staff assigned to the Madoff matters tended to consist of young lawyers, who lacked specific industry experience in options trading and asset management. According to the Inspector General, although receiving three versions of a highly detailed complaint suggesting that Madoff was running a Ponzi scheme under the guise of the split-strike options strategy, the SEC staff looked at front-running and adviser registration issues, but never verified the underlying assets or trading, which would have revealed the fraud. Internal Commission personnel who could have provided valuable options and economic expertise were consulted fleetingly, and failed to follow up when they were consulted by Enforcement.

- ***Silo Mentality:*** The Report is critical of the silos within which different groups operate on the Commission staff. For instance, the report criticizes one examinations team for focusing principally on the broker-dealer issues, and for not including team members from outside that particular chain of command, but who would have brought valuable asset management experience to the team.

- ***Diligence:*** The Report in several places implies that the staff was insufficiently diligent. The staff appears to have relied on the statements of Madoff himself to resolve certain important examination questions, and failed to corroborate those statements. In several instances, the staff gave short shrift to the allegations or complaints about Madoff without conducting sufficient inquiry. In another instance, an enforcement team in one office declined an enforcement referral from another office the day after receiving the referral. The Report suggests that the staff was aware that Madoff had provided inconsistent statements or lied to the staff, but failed to probe further.

- ***Third Parties:*** The Report is highly critical of the staff's numerous failures to obtain information from third parties. For example, in the first examination of Madoff in connection with a 1991 enforcement action, the staff sought trading records from the Depository Trust Company (DTC), but accepted documents produced directly from Madoff and never communicated directly with DTC. (The documents Madoff provided were, of course, forgeries.) On other occasions, the staff could have, but did not, speak directly or sufficiently with foreign securities regulators or domestic self-regulatory organizations.

- ***Influence:*** The Report rejects the suggestion that any member of the SEC staff acted corruptly. The Report does, however, repeatedly refer to the special status Madoff enjoyed as a well-connected member of the securities industry.

- *Planning and Execution:* The Report catalogs numerous instances where the staff's examination was planned too narrowly, and executed too slowly or incompletely. The limited resources of the examination staff are painfully apparent as the Report details the manner in which one of the Madoff examinations was curtailed to devote resources to a larger mutual fund sweep. Many loose ends of the various examinations and investigations were never sufficiently closed, according to the Report.

The Inspector General's Congressional Testimony

On September 10, SEC Inspector General Kotz, testified before the Senate Committee on Banking, Housing and Urban Affairs.[3] In his written testimony, Mr. Kotz repeated a brief summary of his investigation and report. Notably, he also promised to deliver three additional reports concerning policies and practices in OCIE, policies and practices in Enforcement, and the failure of OCIE's investment management arm to conduct an examination of Madoff's asset management business after the staff forced Madoff to register as an adviser in 2006. The Inspector General's written testimony suggests that both the examination and enforcement functions should be less idiosyncratic, better documented, more thorough, and run by more senior and better-trained staff. The additional bureaucratic obligations entailed by the Inspector General's summary recommendations are considerable.

The SEC's Official Response

The Inspector General is independent from, if not adverse to, the Commission and its staff. Chairman Mary L. Schapiro was appointed after the Madoff scheme collapsed, but has been engaged since the day of her appointment in a serious effort to demonstrate to Congress and to the public that the SEC staff is filled with smart, capable civil servants, and can be sufficiently reformed to deserve funding and respect from Congress, and the trust of the nation's investors. The Commission's website has contained an ongoing public list of "Post-Madoff Reforms" that lists general categories of regulatory proposals (surprise exams and third-party reviews to verify client custodial assets); enforcement proposals (restructuring management, specialized practice groups); examination proposals (integrating broker-dealer and investment adviser examinations); public policy proposals (expanded whistleblower bounty payments); and optimistic thinking (recruiting staff with specialized experience, expanding training, obtaining more resources).[4]

Some of these proposals amount to significant changes in the way that the Commission operates; others are mere enlightened common sense in the wake of numerous opportunities missed. We examine several themes of the SEC's responses below:

Increased Focus on Simple Fraud

A number of the SEC's responses focus, sensibly enough, on preventing other would-be or current Madoffs from repeating his feats. The SEC has proposed regulations that would require advisors who maintain custody of clients' assets either themselves or through an affiliate to engage an independent public accountant to conduct once-yearly surprise exams and to attest to controls over and safety of those assets annually. To address the risk of another Madoff in the shorter term, the SEC is conducting a sweep exam of firms with certain risk characteristics (read "Madoff similarities"), including advisers whose clients' assets are held with affiliates, hedge funds that seem to have "smooth" or outlier returns, and firms that use an unknown auditor or no auditor at all. In addition, the SEC proposes to improve the training and techniques of its examiners for detecting fraud. Most significantly, the SEC plans to increase its use of third-party confirmations to verify that customers' reported assets actually exist.

The SEC's repeated failure to confirm Madoff's claimed trades and assets with third parties is roundly criticized in the Inspector General's Report, but there is no discussion in the Report of the risks and costs of a policy of routinely seeking such confirmations. Section 210(b) of the Investment Advisers Act, which empowers the SEC to

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examine and investigate investment advisers, provides that, with limited exceptions,

> **"[T]he Commission, or any member, officer, or employee thereof, shall not make public the fact that any examination or investigation under this title is being conducted, or the results of or any facts ascertained during any such examination or investigation …"**

This provision reflects Congress' recognition of the fact that public knowledge that an examination or investigation is taking place can itself pose a huge risk to an adviser's business, however legitimate that business may be. Investors can be made anxious simply by word that the SEC is looking at an adviser, and an adviser can quickly be put out of business by the withdrawal of customer assets. The confirmation of trades or account balances with non-investor third parties will not necessarily result in the fact of an SEC examination or investigation becoming public, but it may well do so.

As a result, the SEC examination staff has historically been reluctant to contact third parties, because the mere act of doing so runs the risk of violating Section 210(b) and of damaging the reputation of a legitimate adviser and, in the process, harming the adviser's investors. In the wake of the Madoff fraud, the SEC announced in March that it will now request independent confirmation of investor assets from third parties and from investors themselves. Perhaps as contacts with third parties by the SEC become more commonplace there will be less risk to legitimate businesses when such contacts become public.

Breaking Down the Silos

The SEC responses include some modest steps toward breaking down barriers on information flow at the Commission, infamously illustrated by the fact that Madoff himself informed the New York examination staff in 2005 that there was an ongoing cause examination of his operations started by staff in Washington D.C. in 2004. The New York office of the SEC will begin to combine broker-dealer and investment adviser examination staff in joint exam teams for selected firms. Further, the SEC is seeking to apply risk assessment techniques agency-wide to identify firms that require a closer look, as well as increasing collaboration with third parties and government agencies. Finally, the SEC is working to create a central system for storing and analyzing information on complaints and tips.

When reading the Inspector General's Report one is reminded of the fable of the six blind men describing an elephant—each is right about one part of the elephant and taken together all are completely wrong. The tragedy of the SEC's Madoff efforts over the years is that the pieces were all in place for Madoff's fraud to be discovered by the SEC, just never at the same place at the same time. The actions taken and proposed by the SEC in its responses are a modest start at increasing information flow at the agency, but the silos there between divisions, between offices, and between different chains of command within divisions and offices have been built over many years and will take continuing effort over years to break down.

Better Enforcement

The most significant changes announced to date post-Madoff are measures to reorganize and restructure the Division of Enforcement. The new Enforcement Director, Robert Khuzami, has announced that the branch chief position, formerly the first line of management with four to six staff attorneys reporting to each branch chief, will be eliminated.[5] Under the new structure staff attorneys will report to assistant directors, who will supervise fewer staff than under the previous structure. The goal of this change is to apply the expertise of the former branch chiefs more directly to conducting investigations, and eliminate the inefficiencies of an additional layer of bureaucracy. In addition, the Division of Enforcement is forming five specialized groups oriented to particular subject matter areas: Asset Management, Market Abuse, Structured and New Products, the Foreign Corrupt Practices Act, and Municipal Securities and Public Pensions.

The elimination of the branch chief position in the Division of Enforcement is a huge gamble.

Under the resulting reorganization, the first two layers of management in the Division—those closest to the work of investigations—are all arguably worse off. Branch chiefs become staff attorneys, and assistant directors occupy a position that looks a great deal like a branch chief under the old system. The effect that such a realignment will have on morale remains to be seen. Undeniably, the process of bringing an enforcement case within the SEC had become, and had been for years, a punishing exercise in overcoming bureaucratic hurdles, with multiple opportunities for delay. What is unclear is whether the eliminated positions were a significant barrier to good enforcement decision-making, or a help to it.

As for the newly-announced specialized enforcement groups, it is hard to know how effective they will be. As announced the groups will be geographically dispersed, which will be a challenge to their cohesiveness and focus. If, however, they are effective at all, the new groups will have the additional side benefit of forcing enforcement staff to work together across different offices, cooperation that has historically been almost unknown.

Beyond the Official Response: How Will the SEC Change?

Stepping back from the specifics of the SEC's post-Madoff responses and their chances for success, we believe that several trends are likely to characterize the SEC's approach to examinations and enforcement going forward:

More Standardized/Less Flexible

Having been badly embarrassed by the Madoff affair, senior management at the SEC will be understandably focused on reducing the chance of a recurrence. As management of large and complex organizations must, they will turn to standardization of process as a remedy for potential oversights. In the short term this has already led to an increase in reliance on issuance of subpoenas over requests for voluntary productions of documents. In the medium and longer term it will likely lead to the use of templates for different types of investigations.

Such a development could be a positive for SEC enforcement if applied with appropriate caution. The problem with investigation templates is that most investigations, Madoff being an exception, do not come with a label such as "Ponzi scheme." The labels, and the facts, must be developed along the way, and often change in the process. An overreliance on pre-investigation planning and standard methods could lead, again, to staff missing frauds that are hiding in plain sight.

Trust No One

The move toward third-party verifications in examinations will likely be mirrored by a tendency in investigations to request and require documents and facts from third parties. This, in turn, will tend to slow the pace of investigations down, and will also increase the costs of subpoena and document request compliance to repeat industry participants.

More Enforcement-Oriented Examinations

The SEC's examination staff and enforcement staff have not, in general, worked together closely in the past, and often have little information about each other's functions and methods. As this is a weakness that is clearly called out by the Inspector General's Report, we look to see increased coordination between examination staff and enforcement in the future, perhaps involving joint training or periodic rotations between the groups. The result can only be that more examinations will turn into enforcement referrals.

All Deliberate Speed

The SEC's senior management has a difficult needle to thread post-Madoff—they must try to remedy weaknesses in the SEC's systems and processes without encrusting those systems with so much additional guidance that they freeze the entire system into immobility. All this while attempting to make examinations and enforcement *faster* as well as better. Some early signs are encouraging—current management is clearly willing to take some significant risks for a chance of improving the program. It is to be hoped that

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the SEC's efforts post-Madoff will result in both faster and better enforcement.

NOTES

1. The entire Report, *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme,* from the Office of the Inspector General of the Securities and Exchange Commission, can be found at http://www.sec.gov/news/studies/2009/oig-509.pdf.
2. *Inspector General's Report* at 41.
3. Written Testimony of H. David Kotz, Inspector General of the Securities and Exchange Commission, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, September 10, 2009 (http://www.sec-oig.gov/ Testimony/Kotz%20written%20testimony%20before%20Senate%20Banking%20Committee%20(9.10.2009).pdf).
4. "The Securities and Exchange Commission Post-Madoff Reforms," (http://www.sec.gov/spotlight/secpostmadoffreforms.htm).
5. Robert Khuzami, "Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement," August 5, 2009 (http://www.sec.gov/news/speech/2009/spch080509rk.htm).

Sidebar: *More on Madoff*

"No Excuses" for SEC Failure on Madoff, Sen. Dodd Says

A STATEMENT BY SEN. CHRIS DODD

The Senate Banking Committee held a hearing on the recent report issued by the Inspector General of the Securities and Exchange Commission on its investigation into the failure of the SEC to uncover the Bernard Madoff Ponzi scheme. Committee Chairman Chris Dodd (D-CT) conducted the hearing; this is a partial transcript of his statement.

Bernard Madoff stole $50 billion.

He stole from individuals and pension funds and charities and municipalities like Fairfield in my home state. He stole more than money. He stole the retirement savings and the economic security of families across the country. And the Securities and Exchange Commission didn't stop him.

There can be no excuse for that colossal failure. But I demand—the victims of this fraud, some of whom hail from my state and have testified before this committee, demand—an explanation. And so today, we hold our third hearing on Ponzi schemes—and our second on the Madoff fraud in particular—to find out how this could possibly have happened, and what we need to do to make sure it can never happen again.

Incredibly, it emerged late last year that SEC staff had received multiple complaints over a period of 16 years that Madoff's business was not legitimate, but hadn't taken any effective action. To his credit, then-[SEC] Chairman Christopher Cox directed the SEC Inspector

General to conduct a full investigation of why these credible reports had been ignored.

The Inspector General released a report last week, and it is deeply disturbing. As the report indicates, 'The SEC received more than ample information in the form of detailed and substantive complaints," but "a thorough and competent investigation or examination was never performed.'

The report goes on to describe an embarrassing series of internal failures at the SEC:

- Incompetent supervisors directed their offices to look only for the types of fraud they understood and failed to recognize the type actually being committed in the Madoff case;
- Inexperienced SEC staff simply accepted Madoff's claims without making the single phone call or sending the single letter that it would have taken to verify his information;
- No one ever thought it merited a closer look when Madoff said he traded in Europe with a firm that reported there was no activity in the account; and
- Divisions and offices failed to coordinate or share information.

It is ugly stuff. Beginning in 1992 the SEC received information that should have led to a quick end for Bernie Madoff's Ponzi scheme.

But because the task of following up on that information was assigned to junior staff or supervisors with insufficient experience in the securities market, because that staff failed to ask obvious questions or take simple steps to verify what Madoff told them, because their supervisors actually discouraged further investigation—in short, because the SEC failed to do its job, Madoff stole $50 billion.

Today, we will hear from the Inspector General about his report. We will hear from Harry Markopolos, an investment analyst who continually attempted to get the SEC's attention with regards to the Madoff fraud about his ideas for improving the organization. And we will hear from the heads of the Office of Compliance, Inspections, and Examinations and the Division of Enforcement about what the SEC has done in light of the Madoff revelations, and about what Chairman [Mary L.]Schapiro intends to do going forward.

There are several clear steps that should be taken:

- SEC staff should be trained in markets and investment strategies so they can know fraud when they see it, and the SEC should hire staff with real world experience.
- The very culture needs to be reformed to encourage aggressive oversight
- Staff should verify self-serving statements of facts made by targets of investigations.
- Coordination among the SEC's offices and divisions must be improved.
- There should be a more rigorous system for evaluating outside tips and allegations, including articles in the financial press.

Like many Americans, I am stunned and angry that this fraud was allowed to happen. But I also believe that the SEC can do better. And I look forward to discussing how in today's hearing.

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In re Flag Telecom: Additional Limitations on the Scope of Securities Class Actions at the Class Certification Stage

BY STEPHEN W. GREINER & TODD G. COSENZA

Stephen W. Greiner is a partner and Todd G. Cosenza is an associate in the New York office of Willkie Farr & Gallagher LLP. Contact: sgreiner@willkie.com or tcosenza@willkie.com.

The Second Circuit recently issued an important ruling, *In re Flag Telecom Holdings, Ltd. Sec. Litig.*,[1] imposing additional limitations on the scope of securities class actions at the class certification stage. Addressing an issue of first impression at the appellate level in the aftermath of the Supreme Court's decision in *Dura Pharms., Inc. v. Broudo*,[2] the Second Circuit excluded in-and-out traders—those who sold their shares before the end of the class period—from the certified class because plaintiffs had failed to demonstrate loss causation (one of the required elements of a Section 10(b) claim) by a preponderance of the evidence. The Second Circuit has thus reaffirmed both its broad authority to closely scrutinize a district court's class certification decision and the heavy burden on plaintiffs in securities class actions to introduce substantial evidence at the class certification stage.

Factual Background and the District Court's Decision

The litigation stemmed from a February 2000 initial public offering by Flag Telecom Holdings, Ltd. (FLAG), a broadband capacity provider. Plaintiffs alleged that the registration statement for FLAG's IPO contained a misstatement concerning the amount of broadband capacity that FLAG had "pre-sold" at the time of the IPO. Plaintiffs also claimed that, following the IPO, FLAG's public filings included a number of misrepresentations and omissions that painted a falsely optimistic view of the company's prospects and the demand for its products. Plaintiffs alleged that the fraud was revealed to the market on February 13, 2002 when FLAG disclosed that 14% of the company's revenues for the year ending December 31, 2001 resulted from "reciprocal transactions," or "swaps of telecommunications capacity between competitors." The district court noted that although such transactions may be entered into for legitimate reasons, they could also be used to defraud investors by creating "the impression that the company is selling capacity when it is merely unloading useless dark fiber on one of its networks in exchange for useless dark fiber on a competitor's network." After the February 13, 2002 disclosure, FLAG's stock price dropped only 37 cents.

Shareholders—bringing suit under both the Securities Act of 1933 and the Securities Exchange Act of 1934—sought to have a class certified that included all persons or entities who purchased or otherwise acquired FLAG securities between February 16, 2000 and February 13, 2002, as well as all purchasers of FLAG common stock traceable to the company's IPO on February 16, 2000. In opposing class certification, defendants argued, among other things, that in-and-out traders—investors that sold their shares before the February 13, 2002 corrective disclosure that, according to the complaint, revealed the truth of defendants' fraud to the market—should be excluded from the class. Plaintiffs responded that in-and-out traders should remain in the class because some information regarding FLAG's alleged misrepresentations had "leaked" into the market prior to February 13, 2002 and that the disclosure of the leaked information resulted in a significantly larger stock price drop than the post-February 13 decline of 37 cents.

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On September 5, 2007, the district court entered an order certifying a single class consisting of 1) purchasers of common stock traceable to FLAG's IPO that asserted claims under the '33 Act based on the allegedly misleading registration statement; and 2) investors that purchased FLAG common stock between March 6, 2000 and February 13, 2002 asserting certain claims (including under section 10(b) of the '34 Act) based on allegedly misleading statements made after the IPO regarding, among other things, the "reciprocal transactions." The district court included "in-and-out traders" within the second category, finding that it was "conceivable" that those investors could prove loss causation. In fact, the investor selected to represent the class (who is obligated under Rule 23(a) to be an adequate and typical representative for the class) was himself an in-and-out trader.

Defendants sought leave to appeal the district court's decision granting class certification under Rule 23(f), which provides federal appellate courts with the discretionary authority to review a class certification decision immediately. The Second Circuit granted the Rule 23(f) request, thereby allowing defendants to appeal the lower court's decision.

The Second Circuit's Decision

Before addressing the central question of whether in-and-out traders could properly be included in the certified class, the Second Circuit noted that defendants' argument with respect to in-and-out traders implicated both the typicality and the adequacy of representation requirements of Rule 23(a) and, more generally, the court's authority to define the class and the class claims, issues, or defenses pursuant to Rule 23(c)(1)(B). Given that the putative class representative himself was an in-and-out trader, the district court was thus required under Rule 23(a) to find "that he is both an adequate and typical representative of the class and not subject to any 'unique defenses which threaten to become the focus of the litigation.'"

The Second Circuit also resolved an important jurisdictional issue. Plaintiffs argued that the inclusion of in-and-out traders went solely to loss causation (a merits issue), and thus should not be considered on an interlocutory appeal under Rule 23(f). The Circuit Court rejected that argument, noting that in-and-out traders' ability to prove loss causation (especially in light of the status of the putative class representative) could not be "cleanly separated from class certification as to render the issue outside the scope of our Rule 23(f) review." Citing its landmark decision in *In re IPO Sec. Litig.*,[3] the Second Circuit noted that "lower courts have an 'obligation' to resolve factual disputes relevant to the Rule 23 requirements and to determine" whether plaintiffs have proffered sufficient proof to satisfy those requirements "by a preponderance of the evidence." That obligation is "not lessened by overlap between a Rule 23 requirement and a merits issue, even a merits issue that is identical with a Rule 23 requirement." The Second Circuit determined that the lower court "abused its discretion" when it permitted in-and-out traders to remain in the class because the district court's "'conceivable' standard of proof does not satisfy the preponderance of the evidence standard set forth in *In re IPO* and its progeny."

The Second Circuit also found that plaintiffs had not provided "sufficient evidence" that the class representative or other in-and-out traders could prove loss causation and excluded all in-and-out traders from the class. The Court emphasized that in *Dura*, the Supreme Court held that plaintiffs alleging securities fraud under Section 10(b) cannot rely solely on the allegation that they purchased securities at artificially inflated prices. Plaintiffs thus must demonstrate that a company's stock price declined after the truth (or "corrective disclosure") regarding the subject of a defendant's misrepresentation was revealed to the market and must disaggregate the loss caused by the disclosure of the truth correcting a particular misrepresentation from loss caused by disclosures of other information or other factors.

The Circuit Court rejected plaintiffs' "leakage" argument and concluded that in-and-out traders could not meet their burden of establishing loss causation by a preponderance of the evidence. Noting that plaintiffs had previously alleged that FLAG's disclosures prior to February 13, 2002

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were false, the Court commented that plaintiffs "cannot have it both ways" and later argue that these disclosures "revealed the truth with respect to the specific misrepresentations alleged."[4]

Ramifications of the Second Circuit's Decision

The Second Circuit's decision reaffirms that plaintiffs must establish all of the Rule 23 requirements—even those that overlap with a merits issue (such as loss causation)—by a preponderance of the evidence at the class certification stage. Moreover, by excluding in-and-out traders from the class, the *Flag Telecom* decision appears to provide defendants with the ability to restrict the size of the class in a significant way and thereby limit potential damages at the class certification stage.

NOTES

1. *In re Flag Telecom Holdings, Ltd. Securities Litigation*, 574 F.3d 29, Fed. Sec. L. Rep. (CCH) P 95295 (2d Cir. 2009).
2. *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 125 S. Ct. 1627, 161 L. Ed. 2d 577, Blue Sky L. Rep. (CCH) P 74529, Fed. Sec. L. Rep. (CCH) P 93218 (2005).
3. *In re Initial Public Offering Securities Litigation*, 471 F.3d 24, Fed. Sec. L. Rep. (CCH) P 94137 (2d Cir. 2006), decision clarified on denial of reh'g, 483 F.3d 70 (2d Cir. 2007).
4. On August 5, plaintiffs filed a petition with the Second Circuit requesting a rehearing of this appeal *en banc*.

Waive that Privilege Goodbye: Selective Waiver & the Work Product Doctrine

BY RALPH FERRARA & JAMES NORTEY

Ralph C. Ferrara is a partner with Dewey & LeBoeuf and former General Counsel of the United States Securities and Exchange Commission. Mr. Ferrara also is a member of the Editorial Advisory Board of Securities Litigation Report. James Nortey is a second year law student at Harvard Law School. The two worked together to write this article in the summer of 2008. Mr. Ferrara provided the inspiration and the direction for this article. Mr. Nortey provided its intellectual content. Contact: rferrara@dl.com.

The Distinction between Attorney-Client Privilege and Work Product Protection Doctrine

The legal environment is grounded on a series of evolving principles, some as old as the practice of law itself. One such principle is *attorney-client confidentiality* where the correspondence between a lawyer and his client is kept secret in order to encourage the client to be direct and forthright with his attorney. The impetus behind this principle is that justice is best served when the lines of communication between attorney and client are open and honest.

Another such principle is the *work product protection doctrine* which protects information (both material and immaterial) from opposing counsel during the discovery process if that information is prepared in anticipation of litigation. Such information is considered protected from discovery unless the opposing counsel can prove that the protected work product contains evidence needed to support or refute a claim and that there is no other means to acquire that evidence without an undue hardship. For example,

if a defendant's attorney procures a statement from an expert witness, and that witness leaves the country, the opposing counsel would have good reason to obtain the witness statement despite the work product rule. In the event an attorney or client shares protected information with a third party, the information may lose its protected status and may even be considered public information.

In recent times, the lines that once rigidly defined what can and cannot be protected have become blurred. The circuit courts have sent mixed messages with their discordant rulings and at times have allowed a "selective waiver" of work product to be permissible. Some courts, moreover, have confused the law by blending attorney-client privilege and work product protection, sometimes using the terms interchangeably. This judicial sloppiness has resulted in confusion and contradiction in cases of selective waiver.

For the purposes of this article, the term "privilege" will be used in reference only to the confidential and nonpublic communication between a client seeking legal advice and her attorney granting the legal aid; and the word "protection" will only be used to designate the confidential and nonpublic documents and opinions of an attorney that are prepared in anticipation of litigation. This is an important, if sometimes overlooked distinction. It is possible to waive one, without necessarily waiving both. Moreover, not every disclosure of work product is necessarily a waiver of *all* work product. Instead, as we explain below, only disclosures that are inconsistent with the adversarial nature between plaintiff and defendant waive the work product protection.

The work product doctrine originated from a 1947 U.S. Supreme Court case, *Hickman v. Taylor*. [1]At issue was whether the District Court for the Eastern District of Pennsylvania erred when it required the defendant, Taylor, to relinquish protected documents to the plaintiff. The Third Circuit reversed the judgment of the District Court, holding that "the information here sought was part of the 'work product of the lawyer' and hence privileged from discovery under the Federal Rules of Civil Procedure."[2] The Supreme Court upheld the Third Circuit's decision noting that it is pivotal for an attorney to have a certain degree of privacy. Even at the outset of the work product doctrine history, the court mistakenly used the word *privilege* in reference to work product. For the purposes of maintaining a clear distinction between attorney-client privilege and work product protection, we will assume that the court meant to say that, "the information here sought was part of the 'work product of the lawyer' and hence [*protected*] from discovery…"[3]

Attorney work product includes, among other things, interviews, statements, memoranda, correspondence, briefs, as well as attorney mental impressions and personal beliefs.[4] Not all materials prepared in anticipation of litigation, however, are protected. "Where relevant and non-privileged facts remain hidden in an attorney's file and where production of those facts is essential to the preparation of one's case, discovery may properly be had."[5] The work product doctrine was subsequently codified in the Federal Rules of Civil Procedure, under Rule 26(b)(3), stating: "Ordinarily, a party may not discover documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative," unless, "the party shows that it has substantial need for the materials to prepare its case and cannot, without undue hardship, obtain their substantial equivalent by other means."[6]

The Current Debate on the Selective Waiver Doctrine

We now turn to the crux of the issue at hand—the selective waiver doctrine. Selective waiver cases typically arise out of a specific set of circumstance. First, a whistleblower or dissatisfied employee reports some alleged corporate wrongdoing to the government. The government then initiates an investigation and the board of directors of the company negotiates for additional time to conduct their own internal investigation by pledging to fully cooperate with the government investigation. Finally, all too predictably, the company is next notified that it has been named in one or more private lawsuits. As a result, there are at least three relevant parties: (1) a private plaintiff (or plaintiffs); (2) the defendant

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company; and (3) at least one government agency, such as the Department of Justice (DOJ) or the Securities and Exchange Commission (SEC).

A company that finds itself in this situation is now in the untenable position of needing to cooperate with a government investigation by, among other things, waiving its protections while at the same time preserving its ability to defend itself against private plaintiffs. The attorney-client privilege and the work product doctrine would normally prevent a private plaintiff from obtaining privileged and protected documents through discovery. Once privileged information is released to any third party it is generally understood to lose its confidential status. There is, however, no clear understanding regarding protected work product that is released to a third party.

The prevailing view is that protected work product, like privileged information, is waived immediately upon release. Corporations may agree to voluntarily hand over protected documents to the government in order to build a good rapport. Corporations contend that this is only a "selective waiver" of work product meant to comply with a government subpoena and was made with no intention of disclosing protected materials to any non-governmental party. As will be explained in more detail below, there is no consensus view among the circuits that have considered this issue:

- The Eighth Circuit has been the only one to adopt the concept of selective waiver;
- The Second Circuit has left open the possibility of selective waiver at least in the context the of work product doctrine; and
- The D.C., First, Second, Third, Fourth, Sixth, and Tenth Circuits have rejected the selective waiver doctrine.

In 1977, in the case *Diversified Industries, Inc v. Meredith*, Diversified Industries petitioned the Eighth Circuit to review a district court's holding that the company had waived its work product protection.[7] In the preceding trial, *Weatherhead Company v. Diversified Industries, Inc.*, Diversified Industries was involved in litigation and hired an outside law firm to perform an internal investigation. The firm interviewed several employees and prepared a detailed report for the Board of Directors at Diversified Industries. The SEC issued a subpoena requesting documents related to the investigation, and Diversified Industries complied. The plaintiff, Weatherhead Co., attempted to discover the documents in regard to the investigation. Weatherhead had sued Diversified Industries over using a slush fund to bribe Weatherhead employees and conspiring with those employees to sell Weatherhead an inferior grade of copper. Diversified Industries denied the discovery and claimed that the documents were protected under the work product doctrine.[8] The district court held that the information was not protected; however, on appeal, the Eighth Circuit granted a selective waiver of privileged material "[a]s Diversified disclosed these documents in a separate and nonpublic SEC investigation, we conclude that only a limited waiver of the privilege occurred."[9]

In 1993, the Second Circuit in *In re Steinhardt Partners L.P.* left open the possibility of selective waiver for attorney work product when there is common interest between the government and disclosing party or there is an explicit agreement in place between these two parties. However, the court also held that in the absence of these two scenarios, Steinhardt's voluntary disclosure of privileged materials to the SEC waived the work product protections.[10] Specifically, the court held: "we decline to adopt a *per se* rule that all voluntary disclosures to the government waive work product protection. Crafting rules relating to privilege in matters of governmental investigations must be done on a case-by-case basis… Establishing a rigid rule would fail to anticipate situations in which the disclosing party and the government may share a common interest in developing legal theories and analyzing information, or situations in which the SEC and the disclosing party have entered into an explicit agreement that the SEC will maintain the confidentiality of the disclosed material."[11]

Allowing selective waiver, however, raises questions respecting the very nature of privileged information, is at odds with the common understanding of protected information, and is irreconcilable with the rule of law in the United

States. This is evidenced by the fact that a majority of circuit courts have rejected the selective waiver doctrine, *i.e.* D.C., First, Third, Fourth, Sixth and Tenth Circuits.

In 1981—12 years before the Second Circuit's decision in *Steinhardt*—the D.C. Circuit rejected selective waiver of privilege in *Permian Corp. v. United States*.[12] After Permian, a Houston-based oil company, relinquished protected documents to the SEC, the Department of Energy requested the very same documents from the company. The company refused to comply with the request citing attorney-client privilege. The court held that the company "destroyed the confidential status of the… communications by permitting their disclosure to the SEC staff."[13] While voluntary cooperation with the government may be a commendable action, "the client cannot be permitted to pick and choose among his opponents, waiving the privilege for some and resurrecting the claim of confidentiality to obstruct others, or to invoke the privilege as to communications whose confidentiality he has already compromised for his own benefit."[14]

Similarly, in 1997, the First Circuit rejected selective waiver in *United States v. Massachusetts Institute of Technology*.[15] The university sought to retain attorney-client privilege and work product protection after disclosing key documents to an audit agency. The First Circuit held that, "Anyone who chooses to disclose a privileged document to a third party, or does so pursuant to a prior agreement or understanding, has an incentive to do so, whether for gain or to avoid disadvantage… courts have been unwilling to start down this path—which has no logical terminus—and we join in this reluctance."[16] Based on earlier rulings, the Third and Fourth Circuits seem to concur. [17]

As recently as 2002, the Sixth Circuit rejected selective waiver. In *In re Columbia/HCA Healthcare Corp Billing Practices Litigation,* the Sixth Circuit stated "after due consideration, we reject the concept of selective waiver, in any of its various forms."[18] Furthermore, the Tenth Circuit was the latest court to review this topic in 2006—in *In re Qwest Communications International Inc. Sec. Litig.*—and the court rejected the selective waiver doctrine and left very little room for recognizing any protection.[19] Unlike the Second Circuit in *Steinhardt*,[20] the Tenth Circuit found that a confidentiality agreement executed between a disclosing party and DOJ does *not* warrant work product protection because those agreements do not restrict DOJ's ability to share the information with any other agencies while a selective waiver would place undue burden on the lower court to determine the extent of the information shared among the agencies.[21]

Are these rulings fair or accurate? The collective body of circuit courts seems to lump protection under the breadth of privilege and then indiscriminately uses the precedent of waiving privilege to apply to all claims of waiving work product protection. Such reasoning is backwards when the fact of the matter is that work product protection has a larger scope than attorney-client privilege. In fact, work product may include not only an attorney's communications with her client, but also with witnesses, and her own musings regarding key issues.[22]

While corporations may want to disclose materials to gain favor with the government and hope to maintain work product protections with other third parties, these corporations fail to consider the original intent of the work product doctrine as enunciated by *Hickman v. Taylor* and later codified into the Federal Rules of Civil Procedure. The work product doctrine does not exist to protect a confidential relationship. Rather, as the D.C. Circuit has held, the purpose of the work product doctrine is to "promote the adversary system by safeguarding the fruits of an attorney's trial preparations from the discovery attempts of the opponent."[23]

Therefore, a selective waiver of work product to a third party who could be perceived as an adversary will almost always result in a waiver of work product because the production has already disrupted the adversarial system. However, if the disclosure of trial preparations are made in pursuit of litigation and do not disrupt the confidential and adversarial nature of the trial system, that disclosure does not necessarily yield a waiver of work product. As the D.C. Circuit concludes, "While the mere showing of a voluntary

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disclosure to a third person will generally suffice to show waiver of the attorney-client privilege, it should not suffice in itself for waiver of the work product privilege." [24]

This line of thought—where voluntary disclosure of confidential materials would waive the attorney-client privilege but not necessarily work product protection—leads to a range of hypothetical scenarios each deserving due consideration. What if two separate clients engage in a joint-defense against a common adversary or have a similar common interest and subsequently share work product? What if a company enters into a confidentiality agreement with a third party? What if a corporation can prove that divulging protected information to a government agency was used to prepare for litigation? What if two parties share work product as partners and then later enter into an adversarial relationship? Finally, does a disclosure of *some* work product necessarily result in a waiver of *all* work product? Each of these hypothetical issues needs to be examined individually in light of what the courts have ruled.

First, we will address the question of whether selective waiver applies if the disclosing party and the government agency shared a common interest or entered into a confidentiality agreement. The Second Circuit might be more willing to grant selective waiver in this context whereas the Tenth Circuit and courts following the Tenth Circuit might reject selective waiver. In 2007, a ruling by a Southern District of New York court in *In re Cardinal Health, Inc. Sec. Litig.* upheld "selective waiver" by relying on the "common interest" between the Audit Committee of Cardinal Health and the government agencies in "developing legal theories and analyzing information"—stating this situation would be "foreseeable" by *Steinhardt*. [25]In that case, the Audit Committee engaged its own separate litigation counsel—the law firm Kramer Levin Naftalis & Frankel LLP, to conduct an independent investigation on the improper accounting practices and issues within Cardinal.[26]

In reaching this holding, the district court emphasized the fact that two government agencies, the SEC and United States Attorneys' Office (USAO) "worked closely, shared issues, evidence, and theories" with the independent counsel Kramer Levin.[27] Furthermore, the court pointed out that: "On a number of occasions, the SEC advised Kramer Levin of documents and allegations of which its lawyers had become aware and asked Kramer Levin to investigate these issues."[28] In that case, the disclosing party had a confidentiality agreement with the SEC but not the USAO. However, the court upheld the selective waiver doctrine for materials shared with both agencies based on "common interest" between the disclosing party and the government agencies in "developing legal theories and analyzing information."[29]

In *United States v. American Tel. & Tel. Co.*,[30] the D.C. Circuit Court held, "Common interests should not be construed as narrowly limited to co-parties. So long as transferor and transferee anticipate litigation against a common adversary on the same issue or issues, they have strong common interests in sharing the fruit of the trial preparation efforts."[31] Furthermore, "When the transfer to a party with such common interest is conducted under a guarantee of confidentiality, the case against waiver is even stronger."[32]

Next, let's examine the issue of having the government on one's side in anticipation of litigation. This is a bit of a misnomer because as far as the law is concerned, the government is rarely on the side of any one private person or party, but acts on behalf of the people as a whole. Therefore, if a corporation is already involved with a government investigation, the company's claim that it has a common interest with the government becomes more complicated. Simply put, if a government agency has already initiated an investigation of a company, than that company is already under suspicion of violating the law.

There are only two ways to impart information to the government: by coercion or voluntarily. As previously mentioned in *Cardinal Health*, the Second Circuit ruled that voluntary disclosure waives work-product protection while leaving the possibility of selective waiver open in specific sets of circumstances. But what about a government subpoena? In most cases the SEC or DOJ will subpoena information under threat of punishment. Is a response to a government subpoena coerced or voluntary? A company can choose to comply with the subpoena, present the required information,

and waive their protection. Or they could choose to refuse to comply, maintain its work product protection, and risk government sanctions. Both of these seem to be grim prospects at best. A third option (and perhaps the best option) is a motion to quash. Quashing a government order voids a subpoena entirely. A court can quash a subpoena if a party can prove that a compliance with the subpoena would violate some constitutional right or create an undue burden (such as waiving work product protection).

A party engaged in a common interest with a second party may be able to protect their work product. So, what if a company enters into a confidentiality agreement with the government where there is a pending investigation? In *Westinghouse Elec. Corp. v. Republic of the Philippines*, the Third Circuit ruled that a company cannot claim to be on friendly relations with the government, if a government agency is investigating the company.[33] In those instances the government will be treated as an adversary and any disclosure to the government will constitute a waiver of work product protection.[34] But, then again, who wants to force a "non cooperation" assertion by prosecutors at the close of an inquiry where enforcement action is threatened?

Next, what about the scenario where two former parties shared work product, and then later became adversaries. After all, the courts have consistently demanded that any disclosure of work product must preserve the adversarial nature of the case. *United States v. Gulf Oil Corp.* represents such a setting where Cities Service Oil & Gas Corp. (Cities) and a second company, Gulf Oil Corp. (Gulf), were preparing to merge into one company.[35] Both companies entered into a merger agreement granting full access of all business records to each other.[36] Ultimately, the merger was terminated, and ironically enough, the two companies later became legal adversaries.[37] Furthermore, the Department of Energy initiated an investigation of Cities' business transactions.[38]

Cities turned over some documents, but it refused to surrender memoranda related to internal counsel's analyses regarding an upcoming suit citing work product protection.[39] The Temporary Emergency Court of Appeals ruled that, "Gulf and Cities were obviously not adversaries at the time of disclosure."[40] Furthermore, even though an adversarial relationship developed between the two, "this was not the case at the time the disclosure was made," and therefore the work product protection was not waived.[41] Therefore, the timing of entering into an adversarial relationship whether before or after a disclosure does not signify a waiver of protection as long as the two parties had a common interest at the time of the disclosure.

All told, it does not appear that subject-matter waiver applies to the work product doctrine. That is, unlike attorney-client privilege, a partial work product waiver does not necessitate complete waiver of all related material. This distinction is grounded in the distinct purposes of the two principles. The attorney-client privilege exists to promote confidential and honest communication, while the work product doctrine does not. The only time a waiver of work product is in order, is if and only if, a party subverts the adversarial balance by giving work product to the opposing party. As articulated by the D.C. district court in *In re United Mine Workers of America Employee Benefit Plans Litigation*, creating a subject-matter waiver of work product is inconsistent with the law. After all, "the law does not mandate a subject-matter waiver and such a waiver is more likely to undermine the adversary system than to promote it."[42]

Backlash

The confusing, sometimes contradictory, and often perceived as unfair case law regarding these issues led many legal professionals and organizations to advocate reform.

Many have called for regulation to check the power of white-collar enforcement agencies such as the SEC and DOJ. Companies, after all, are primarily motivated to waive their protections out of fear that they will be deemed to be uncooperative.

To take but one example, the version of the new rule of Federal Rule of Evidence 502 that the Advisory Committee initially proposed in April 2006 directly addressed the selective waiver doctrine.[43] That provision, however, "was cut from the final draft of the rule as enacted, and it is un-

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clear what this means for the survival of the selective waiver doctrine."[44]

After many years of false-starts and set backs, reform efforts gained increased traction on multiple fronts starting in the second half of 2008.

First, in July of 2008, ranking minority member of the Senate Judiciary committee, Sen. Arlen Specter (then-R, now-D-PA) reintroduced the "Attorney-Client Privilege Protection Act of 2008" in the hope of changing corporate litigation policy in regards to privileged and protected material. Specter's bill would ban any agency of the federal government from requesting or demanding the disclosure of any material guarded by the attorney-client privilege or attorney work product protection. The bill would also forbid government agencies from establishing any charge or adverse treatment on whether a company pays attorney fees for its employees or signs a joint defense agreement.[45] The bill, however, has yet to pass and only time will tell if the selective waiver issue will ultimately be decided by the executive agencies, the legislature, the federal courts, or a combination of all three.

Second, the DOJ issued a new memorandum authored by Deputy Attorney General Mark R. Filip entitled "Principles of Federal Prosecution of Business Organizations." The Filip Memo replaces the much maligned "McNulty Memo" as the DOJ's guidelines for charging corporations.[46] The Filip Memo revises the policy articulated in the McNulty Memo in several important ways. It, perhaps most importantly, prohibits prosecutors from requesting waivers of "core" work product or attorney-client privileged information and forbids rewarding corporations that do provide such information.

Third, in *U.S. v. Stein*, the Second Circuit affirmed a district court decision holding that the government violated the Sixth Amendment Right to counsel of former officers and directors by pressuring the company for whom they worked to refuse to indemnify them.[47]

Finally, in October 2008, the SEC released its enforcement manual, often referred to as the "Red Book," to the public for the first time. The manual admonished that SEC "staff should not ask a party to waive the attorney-client or work product privileges and is directed not to do so."[48]

While a full treatment of these developments and their implications is beyond the scope of this article, recent events auger well for the much needed clarity concerning attorney-client privilege and the work product doctrine.

Conclusion

So what can be said definitively and conclusively about the permissibility of selective waiver? It is a gamble because the jury is still out and no clear verdict is in sight. Although, some would like to have the Supreme Court settle the issue once and for all, there are so many factors to be taken into account when analyzing a selective waiver case (confidentiality agreements, opinion vs. non-opinion work product, government investigations, etc.) that the high court could never make a clear, concise, and all encompassing decision to clarify when a selective waiver is admissible.

A more plausible solution would be to have Congress pass a bill that either grants or forbids selective waiver in courts like that supported by Sen. Specter. Such a bill should only grant a selective waiver when a disclosure is made exclusively to a government agency undergoing an investigation. The bill should clarify that the government is a neutral party outside the case between plaintiff and defendant, and thus not an adversary. Nevertheless, before the selective waiver issue can be resolved, it is vitally important that the legal community make a stark distinction between the principles of attorney-client confidentiality which grants a privileged status to communications and the work-product protection doctrine which protects an attorney's work product.

To continue to confuse the two concepts does not administer justice to current or future cases. The courts have handed down a series of murky precedents which provide a service to no one. The path of the law needs to be predictable. It ought not leap too quickly, but evolve slowly to match the trends of our time. However, it should not be sporadic, out of touch, or inconsistent either. Should we forget, a legal infrastructure establishes order in society and sustains the American way of life? Much more than a business transaction is lost when the government cannot create and adjudicate sound rulings.

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NOTES

1. *Hickman v. Taylor*, 329 U.S. 495, 67 S. Ct. 385, 91 L. Ed. 451, 1947 A.M.C. 1 (1947).
2. *Hickman*, 329 U.S. at 500.
3. *Hickman* (emphasis added).
4. *Hickman*, 329 U.S. at 511.
5. *Hickman*, 329 U.S. at 511.
6. Fed. R. Civ. P. 26(b)(3).
7. *Diversified Industries, Inc. v. Meredith*, 572 F.2d 596, 1977-2 Trade Cas. (CCH) ¶ 61591, 1978-1 Trade Cas. (CCH) ¶ 61879, 23 Fed. R. Serv. 2d 1473, 24 Fed. R. Serv. 2d 1201 (8th Cir. 1977) (rejected by, Republic of Philippines v. Westinghouse Elec. Corp., 132 F.R.D. 384, 17 Fed. R. Serv. 3d 1476 (D.N.J. 1990)) and (disapproved of by, U.S. v. Massachusetts Institute of Technology, 957 F. Supp. 301, 97-1 U.S. Tax Cas. (CCH) P 50269, 37 Fed. R. Serv. 3d 711, 79 A.F.T.R.2d 97-595 (D. Mass. 1997)) and (rejected by, In re Columbia/HCA Healthcare Corp. Billing Practices Litigation, 293 F.3d 289, 58 Fed. R. Evid. Serv. 1451, 53 Fed. R. Serv. 3d 789, 2002 FED App. 0201P (6th Cir. 2002)).
8. Jody E. Okrzesik, *Selective Waiver: Should the Government be Privy to Privileged Information Without Waiving the Attorney-Client Privilege and Work Product Doctrine?*, 34 U. Mem. L. Rev. 115 (2003-2004).
9. *Diversified Industries*, 572 F.2d at 611.
10. *In re Steinhardt Partners, L.P.*, 9 F.3d 230, 236, Fed. Sec. L. Rep. (CCH) P 97818, 27 Fed. R. Serv. 3d 726 (2d Cir. 1993) (rejected by, In re Columbia/HCA Healthcare Corp. Billing Practices Litigation, 293 F.3d 289, 58 Fed. R. Evid. Serv. 1451, 53 Fed. R. Serv. 3d 789, 2002 FED App. 0201P (6th Cir. 2002)).
11. *Steinhardt*.
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21. *Qwest*, 450 F.3d at 1194.
22. *See above* Section I on the distinction between the attorney-client privilege and work product protection.
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Components and United States Attorneys (Aug. 28, 2008); Principles of Federal Prosecution of Business Organizations, Memorandum from Paul J. McNulty, Deputy Attorney General, to Heads of Department Components and United States Attorneys (December 12, 2006).

47. *See U.S. v. Stein*, 541 F.3d 130, 2008-2 U.S. Tax Cas. (CCH) P 50518, 102 A.F.T.R.2d 2008-6023 (2d Cir. 2008).

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Running the Numbers

One-Third of Execs Expect Rise in Fraud & Misconduct, KPMG Survey Finds

Tough economy, infusions of government cash may require more internal controls, execs say

Amid a continuing economic downturn, renewed government regulatory enforcement and with trillions of dollars of government money infused into the U.S. economy, nearly one-third of corporate executives—32% of respondents—expect fraud or misconduct to rise in their organizations, according to a survey by KPMG LLP.

In addition, two-thirds of the respondents said combating fraud and misconduct may require more improvements in corporate internal control environments, the survey found.

"Amidst the current economic downturn, and the pledges of renewed vigor of regulatory enforcement, our 2008–2009 Fraud Survey reveals serious challenges confronted by leaders in the public and private sectors," reported Richard H. Girgenti, the National Practice Leader of KPMG Forensic.

Since the latest economic downturn began, vast sums of market capitalization have been wiped out. Trillions more have been committed to stabilizing financial institutions, injecting liquidity into the capital markets, and jumpstarting the economy through infrastructure spending programs. The aftermath of the downturn has further uncovered numerous Ponzi schemes that caused investors to watch billions more vanish.

Aside from questioning where yesterday's money went, many remain concerned about where

tomorrow's money is going. To be sure, record levels of government spending may usher in record levels of fraud, waste, and abuse. Deals made to offload toxic assets may be exposed to self-dealing. In those industries outside the center of direct government intervention, managers may face downward pressure to do whatever it takes to "make the numbers" as analysts and creditors scrutinize financial results. And for those companies operating outside the United States, increased investigation and prosecution of anti-bribery and corruption laws mean employees and agents may trigger risks like never before.

The KPMG survey reveals the perceptions of senior executives across this new landscape as they consider the nature of fraud and misconduct risks in their organizations going forward, and the challenges they confront in their efforts to prevent, detect, and respond to such risks. Among the key findings:

- Nearly a third of executives expect some form of fraud or misconduct to rise in their organizations. Roughly one-third of respondents (32%) said at least one of the categories of fraud (misappropriation of assets, fraudulent financial reporting, and other illegal or unethical acts) was going to increase during the next 12 months in their organization.

- The majority of executives cite fraud and misconduct as posing significant risks to their industry today. Nearly two-thirds of executives (65%) reported that fraud and misconduct is a significant risk for their industry. If such wrongdoing were to be experienced, the greatest concern for over two-thirds of executives (71%) is the potential for a loss of public trust when market confidence is at a premium.

- Executives expect the threat of fraud to remain steady or rise in the coming year. About three out of four executives believed that fraud and misconduct risks, such as misappropriation of assets and fraudulent financial reporting, will either stay the same or increase over the next 12 months (85% and 74%, respectively).

- Inadequate internal controls or compliance programs heighten the risks of fraud and misconduct. Two-thirds of executives (66%) reported that inadequate internal controls or compliance programs at their organizations enable fraud and misconduct to go unchecked.

- Gaps exist in plans in place to address allegations of wrongdoing. Roughly a quarter of respondents (27%) lack effective protocols on how investigations should be conducted and at what point the board of directors should be alerted to potential concerns. Likewise, roughly a third (33%) lacked protocols on how to remedy control breakdowns.

- Executives acknowledge room for improvement across most elements of their antifraud efforts. Those areas where respondents cited the most amount of improvement needed include employee communication and training, technology-driven continuous auditing and monitoring techniques, and fraud and misconduct risk assessment (with 67%, 65%, and 60% of respondents, respectively, identifying at least moderate improvements needed).

"Succeeding in these turbulent times requires business leaders to ensure their controls are up to the challenge of confronting the fraud and misconduct risks in today's environment," reported KPMG's Girgenti. "While lawmakers consider the possibility of systemic changes in regulations (and regulators), those companies that lead through better self-regulation will be equipped to shine their own light on a way forward."

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Perceived Fraud & Misconduct Risks

The survey began by asking senior executives whether they viewed fraud and misconduct to be significant risks within their industry. Nearly two-thirds (65%) of all respondents answered in the affirmative. *(See Graph 1 below.)*

Q. Do you perceive fraud and misconduct to be a significant risk for your industry today? *(May not add up to 100% due to rounding.)*	
Yes	65%
No	34%

Source: KPMG, 2008–2009 Fraud Survey.

These results dovetail with the results from KPMG Forensic's 2008–2009 Integrity Survey, wherein 74% of employees nationally reported that they had personally observed or had first-hand knowledge of wrongdoing within their organization during the previous 12 months.[1]

Nature of Perceived Fraud & Misconduct Risks

Next, the survey sought to examine which categories of fraud and misconduct that executives believed pose the most significant risk to their organizations, allowing respondents to select from one of four categories, as shown in Graph 2 below.

Q. Which of the following categories of fraud and misconduct pose the most significant risk to your organization? *The nature of perceived fraud and misconduct risks varied by industry, for example, executives from consumer markets were more likely to cite asset misappropriation as a concern, whereas respondents from healthcare and pharmaceuticals tended to cite other illegal and/or unethical acts (such as bribery, corruption, market rigging, or conflicts of interest) as threats.*	
Misappropriation of assets (e.g., theft of cash, inventory, or intellectual property)	35%
Other illegal or unethical acts (e.g., bribery, corruption, market rigging, or conflicts of interest)	31%
Fraudulent financial reporting (e.g., intentional misstatement of revenue, assets, or liabilities)	14%
All three are an equal threat	20%

Source: KPMG, 2008–2009 Fraud Survey.

NOTES

1. See KPMG Forensic Integrity Survey 2008–2009. Available at www.us.kpmg.com.

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