

## Delaware Chancery Court Replaces Co-Lead Counsel for Putative Shareholder Class Representatives and Questions Previous Settlement in *Revlon* Case

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On March 16, 2010, Vice Chancellor J. Travis Laster of the Delaware Court of Chancery issued a harshly worded opinion, censuring and ultimately replacing co-lead counsel for the putative shareholder representatives who challenged a proposed merger between Revlon, Inc. and its controlling shareholder, MacAndrews & Forbes Holdings, Inc. (MacAndrews & Forbes). *In re Revlon, Inc. Shareholders Litigation*, Consol. C. A. No. 4578-VCL (Del. Ch. March 16, 2010). The 46-page decision will no doubt generate copious commentary regarding the newest vice chancellor's views of what he refers to as "frequent filer" plaintiffs' counsel in shareholder class actions, but a closer reading shows that the opinion also provides valuable lessons for those *defending* shareholder suits.

### BACKGROUND

On April 13, 2009, MacAndrews & Forbes proposed a merger to acquire all of Revlon's publicly traded Class A Common Stock, in which Revlon's public stockholders would receive new Series A Preferred Stock rather than cash (Original Merger). Shortly after the announcement of the Original Merger, four representative shareholder actions were initiated by plaintiffs' firms, viewed by Vice Chancellor Laster as "frequent filers" – *i.e.* firms which frequently engage in the opportunistic filing of rep-

resentative actions on behalf of shareholders with small ownership stakes, only to let the litigation lie dormant until settlement and the collection of their fees.

True to form, the Revlon shareholders' actions advanced, in Vice Chancellor Laster's words, "the generic theory that MacAndrews & Forbes was trying to capture the benefits of an internal Revlon restructuring before they were recognized by the market" (Slip. Op. at 4-5). After a flurry of controversy among the four "frequent filer" plaintiffs' firms concerning who should serve as lead counsel, plaintiffs' attorneys ultimately designated two of the law firms as co-lead counsel.

### THE 'KABUKI DANCE' AND CESSATION OF ALL LITIGATION

Much to Vice Chancellor Laster's displeasure, after the plaintiffs' counsel's leadership structure was established, all litigation activity appeared to cease. The plaintiffs simply stopped pursuing their case. They made no effort to compel the defendants' responses to discovery that had been served before consolidation; nor did they propound any new discovery. The plaintiffs even looked the other way when the defendants failed to file an answer to the complaint. In short, "no one actually litigated anything" (Slip Op. at 8).

Vice Chancellor Laster described this behavior as typical of the "*Cox Communications* Kabuki Dance." According to the court, the choreography of this Kabuki dance generally involves two dual tracks. On the "transactional track," a company that is working toward effectuating a merger engages in negotiations

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DEFENSE COUNSEL SHOULD AVOID SIGNING SETTLEMENT AGREEMENTS OR MOUs THAT MISREPRESENT OR EXAGGERATE THE ROLE OF A PLAINTIFF'S COUNSEL (OR THE SHAREHOLDER LITIGATION) IN IMPROVING SHAREHOLDER VALUE.

and secures experts to opine on the fairness of the proposed deal. Simultaneously, on the “litigation track,” plaintiffs’ attorneys rush to file representative suits against that company as soon as possible after the announcement of the proposed deal, and then fight to install themselves as lead counsel. Shortly thereafter, however, the attorneys cease any actual litigation on the case and, instead, concentrate on securing a settlement which will allow them to collect their fee, regardless of whether the resulting merger is, in fact, fair to the shareholder class the attorney supposedly represents. In Vice Chancellor Laster’s view, when plaintiffs’ attorneys engage in this type of conduct, they fail to fulfill their intended role as watchdogs over corporate management and fail to prevent loss in shareholder value.

For instance, the court found in *Revlon* that the attorneys who were appointed co-lead counsel had failed to notice, let alone act upon, a series of events unfolding on the transactional track that should have alerted them that there was a legitimate challenge to the merger. Barclays Capital, Inc., financial advisor to Revlon’s special litigation committee, had indicated that it would not be able to render a fairness opinion for the MacAndrew & Forbes proposed merger. As a result, MacAndrews & Forbes’ counsel concluded that it was necessary to bypass the special litigation committee and its financial advisor, and suggested that MacAndrews & Forbes alter its bid from a merger to a tender offer, which would allow the Class A holders to exchange their shares for the Series A Preferred.

While these developments should have, in Vice Chancellor Laster’s words, “piqued the interest of a properly motivated

plaintiffs’ lawyer” (Slip Op. at 10), co-lead counsel did nothing. To the contrary, they actually blessed the proposed tender offer and then entered into a Memorandum of Understanding (MOU) with defense counsel to settle the representative lawsuits. The parties submitted this MOU to the court on August 14, 2009. The MOU stated that the tender offer provided a basis for settling the litigation that was “fair, reasonable and adequate and in the best interests of Revlon’s stockholders as well as Revlon” (Slip Op. at 17). Revlon then proceeded with the tender offer.

#### THE NEW ‘CLASS’ AND SECOND ROUND OF LITIGATION

Many of Revlon’s other shareholders did not agree that the settlement and corresponding tender offer were in the best interest of the shareholder class. In December 2009, several new groups of shareholders brought suit, challenging the fairness of the tender offer and questioning the terms of the previous settlement MOU. These actions were brought by various plaintiffs’ firms.

In response, defense counsel sprang into action to defend the MOU, but Vice Chancellor Laster was not entirely convinced that the MOU should be honored. In reviewing the MOU, the court found that it contained a number of assertions which were, at best, gross exaggerations, and, at worst, outright misrepresentations. In the court’s view, the MOU included numerous inconsistencies meant to exaggerate co-lead counsel’s role in the merger negotiations. Vice Chancellor Laster was particularly suspicious of co-lead counsel’s claim that their “substantial factual and legal research” played a major part in forcing the alteration of the bid from a merger to a tender offer. He discounted this claim, finding instead that the absence of any docket activity clearly indicated that the plaintiffs’ efforts to “explore, establish, or confirm any facts” were far from substantial (Slip Op. at 20). In the court’s view, it was not the plaintiffs’ (nonexistent) litigation, but Barclay’s refusal to opine on the fairness of the merger, which led to the alteration of the bid. Vice Chancellor Laster concluded that the plaintiffs’ assertions in the MOU were “supported by little more than punctuation” (Slip Op. at 33). He further noted that defense counsel also made representations in the MOU that did not appear to be borne out by the record, presumably to avoid litigation over a tender offer that would be subject to (and perhaps would fail) an entire fairness review.

In short, the court concluded that “[t]he memorandum of understanding to which [co-lead counsel] agreed raises serious questions about whether they focused foremost on the interests

of the class, or instead settled on terms that would be easy gives for the defendants while still arguably sufficient to support a release and a fee” (Slip Op. at 1). Consequently, Vice Chancellor Laster found that co-lead counsel had failed to sufficiently litigate the case or represent the shareholders adequately. In an effort to ensure that the class would be adequately represented going forward, he removed the original plaintiffs’ counsel, and appointed new co-lead counsel. Vice Chancellor Laster also directed new counsel to evaluate whether the previous settlement was fair.

Although Vice Chancellor Laster levels his caustic criticisms primarily against “frequent filer” plaintiffs’ counsel, his decision carries valuable lessons for lawyers on the defense side:

First, attorneys must at all times exercise the utmost candor when dealing with the court. Vice Chancellor Laster was clearly dismayed that the parties entered into, and submitted to the court, a document that he believed contained numerous exaggerations and misrepresentations. His proclamation that counsel “approached the concept of candor to the tribunal as if attempting to sell me a used car” (Slip Op. at 1), is likely to be cited for many years to come. Defense counsel should avoid signing settlement agreements or MOUs that misrepresent or exaggerate the role of a plaintiff’s counsel (or the shareholder litigation) in improving shareholder value. While such shading of the truth may be a tempting way to expedite the resolution of a shareholder action, it ultimately may damage the defense attorney’s credibility with the court and impair his ability to effectively represent his clients going forward.

Second, defense counsel should be aware that a settlement agreement entered into with plaintiffs’ counsel who fail to properly litigate their clients’ claims or otherwise fail to adequately represent the interests of the shareholder class may be questioned by the court or subject to further shareholder litigation. As evidenced by his decision in *Revlon*, Vice Chancellor Laster – as well as other judges who believe in the vigorous protection of shareholders’ rights – will not simply rubber-stamp a settlement or MOU that unfairly favors a corporation at the expense of its shareholders due to poor advocacy by plaintiffs’ counsel. He also will not prevent other shareholders from coming forward to challenge an unfair merger or settlement previously entered into under the watch of inattentive plaintiffs’ counsel.

## Vivendi Trial Verdict: One of Only Nine Since Enactment of the PSLRA in 1995 Based on Post-Reform Act Conduct

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On January 29, 2010, following a three-month trial and three weeks of deliberations, the jury in *In re Vivendi Universal, S.A.*, No. 02-Civ.-5571, found Vivendi liable for federal securities Rule 10b-5 violations based on 57 material misstatements by the company. Damages for the class could exceed \$9 billion. The jury absolved the company’s former CEO Jean-Marie Messier and former CFO Guillaume Hannezo of liability. According to Adam Savett of RiskMetrics Group, the *Vivendi* case is only the ninth securities class action lawsuit tried to a verdict since passage of the Private Securities Litigation Reform Act in 1995 based on post-PSLRA conduct. Most securities litigation cases are settled or dismissed. Vivendi has vowed to appeal.

### BACKGROUND

Plaintiffs alleged that Vivendi made materially false and misleading statements about its liquidity and overall growth that inflated the company’s share price between October 2000 and August 2002. During this period, Vivendi embarked on an aggressive quest to transform from a French water utility company into a global media and telecommunications conglomerate. Central to that strategy were the acquisitions of The Seagram Company, which owned Universal Pictures and Universal Music Group, and Canal Plus S.A., one of Europe’s largest cable television operations, as well as a host of other acquisitions, including Houghton Mifflin Co., Studio Canal, and USA Network Entertainment. The acquisitions increased Vivendi’s debt from 3 billion euros to 21 billion euros.

During the class period, Vivendi’s CEO, Mr. Messier, repeatedly assured investors that financial results were “very strong” and that Vivendi had a “healthy balance sheet.” Eventually, in July 2002, Mr. Messier resigned among a series of market rumors that

Vivendi had hidden liabilities. Soon thereafter, the company's new CEO admitted that Vivendi "was [then] facing a liquidity problem." The new CEO further stated in September 2002 that if Mr. Messier remained CEO beyond the date he resigned, the company would have gone bankrupt "within 10 days." Plaintiffs alleged that the company misled investors about Vivendi's true liquidity position and overall growth through various public statements at the same time the company was suffering massive losses and increased debt.

#### EARLY LITIGATION LOSSES

Many securities fraud cases are dismissed or settle prior to trial; *Vivendi* was not. Judge Baer of the District Court for the Southern District of New York denied Vivendi's motion to dismiss for lack of subject matter jurisdiction and for failure to state claims under §§ 11, 12(a)(2), and 15 of the Securities Act of 1933, and §§ 10(b) and 20(a) of the Securities Exchange Act of 1934. *In re Vivendi Universal, S.A. Sec. Litig.*, 381 F. Supp. 2d 158 (S.D.N.Y. 2003). The court granted dismissal of the §14(a) claim under the 1934 Act and the §12(a)(2) claim under 1933 Act against Mr. Hannezo, but permitted plaintiffs the opportunity to amend their complaint.

Specifically, Vivendi sought dismissal of claims brought by certain "foreign-cubed" investors - foreign plaintiffs who purchase shares of a foreign company on foreign stock exchanges - for lack of subject matter jurisdiction. The court applied the Second Circuit's "conduct test," and held that it had jurisdiction over the foreign-cubed plaintiffs' claims because Vivendi's conduct in the United States was more than merely preparatory to the fraud, and particular acts within the United States directly caused losses to foreign investors. Those acts included the plan to acquire U.S. entertainment and publishing companies, and the fact that Messrs. Messier and Hannezo spent half of their time in the United States soliciting U.S. investors.

The court also denied challenges to plaintiffs' Rule 10(b) claims because plaintiffs pleaded sufficient facts to provide a reasonable belief that Vivendi knew its statements regarding the company's financial health and liquidity were false, and that Vivendi indeed had a liquidity problem. The court further denied Vivendi's safe-harbor defense (cautionary language insufficient) and truth-on-the-market defense (too fact-intensive and rarely an appropriate basis for dismissal), and concluded that the statements were more than merely inactionable puffery. The court also held that plaintiffs sufficiently alleged scienter (the company had motive

OF THE NINE CASES TRIED TO A VERDICT, AFTER POST-VERDICT MOTIONS AND APPEALS, THE VERDICTS FAVOR DEFENDANTS FIVE TO FOUR. THIS NEARLY 50-50 SPLIT DEMONSTRATES WHY MOST SECURITIES CLASS ACTION CASES DO NOT GO TO TRIAL, AND WHY PARTIES SETTLE WHEN THEY ARE UNABLE TO ACHIEVE AN EARLIER DISMISSAL — THE UNCERTAINTY AND POTENTIAL LIABILITY ARE TOO GREAT.

to commit fraud to acquire more companies, and Vivendi knew or should have known it misrepresented material facts about the company). For many of the same reasons, the court denied Vivendi's motion to dismiss plaintiffs' §§ 11, 12, 15 and 20 claims.

Vivendi sought reconsideration of its motion to dismiss, which newly presiding Judge Holwell denied. *In re Vivendi Universal, S.A. Sec. Litig.*, 2004 U.S. Dist. LEXIS 21230 (S.D.N.Y. Oct. 19, 2004). He wrote an opinion to specifically address whether the court had subject matter jurisdiction over the foreign plaintiffs' Rule 10(b) claims. Again applying the "conduct test," the court concurred with Judge Baer's decision finding jurisdiction over this dispute. Additionally, Judge Holwell stressed the significance of the fact that Vivendi's two top executives resided and ran the company from the United States during the final year of the class period. The court further denied Vivendi's request to certify an interlocutory appeal.

Plaintiffs subsequently moved to certify a class that encompassed domestic and foreign persons who purchased or otherwise acquired Vivendi common shares on foreign exchanges and American Depository Shares on the New York Stock Exchange between October 30, 2000 and August 14, 2002. *In re Vivendi Universal, S.A. Sec. Litig.*, 242 F.R.D. 76 (S.D.N.Y. 2007). Viven-

di argued that all foreign plaintiffs needed to be excluded from the class because of the “near certainty” that the company would be unable to assert claim preclusion to bar subsequent actions in countries where foreign plaintiffs reside. The court disagreed and certified a class of plaintiffs that included persons from the U.S., France, England, and the Netherlands because it concluded it was more likely than not that courts in these countries would recognize the enforceability of a judgment or settlement in the present case. The court’s class certification order declined to include plaintiffs from Germany and Austria because it was more likely than not that courts in these countries would not give res judicata effect to judgments or settlements in a U.S. opt-out class action.

Vivendi’s attempts to have this securities fraud case against it dismissed prior to trial ended in April 2009 when the court denied its motion for summary judgment. *In re Vivendi Universal, S.A. Sec. Litig.*, 634 F. Supp. 2d 352 (S.D.N.Y. 2009). Vivendi moved for summary judgment against all plaintiffs based primarily on a failure to prove loss causation. Citing Second Circuit precedent, the court reasoned that “[l]oss causation is the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff.” Plaintiffs seeking to prove loss causation must show a connection between the alleged facts or misleading statements and one or more events disclosing the truth concealed by that fraud, and a connection between these events and actual share price declines. *See Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005). The court held that plaintiffs presented a genuine issue of material fact with regard to Vivendi’s alleged concealment of a severe liquidity risk, whether that risk was revealed to the market, and if these events caused the losses. Vivendi’s motion for summary judgment was denied and the case proceeded to trial.

#### VIVENDI FOUND LIABLE FOR 57 MATERIAL MISSTATEMENTS, PLANS TO APPEAL

On October 5, 2009, after years of pre-trial motions and preparation, the jury trial began. Following a three-month trial and three weeks of deliberation, the jury reached a verdict on January 29, 2010, finding Vivendi liable for 57 material misstatements. The jury exonerated Vivendi’s former executive officers, Messrs. Messier and Hannezo, of any personal liability. The verdict may entitle plaintiffs to recover as much as \$9.3 billion in damages. Of course, the actual amount of damages cannot be fully estimated at this time because final payout depends on how many investors were actually in the class and whether they will all seek

their payout. Each class member’s individual payout will hinge on a number of factors, including number of shares held and the purchase and sale dates.

Vivendi has stated that it plans to appeal and have the verdict overturned. For now, grounds for appeal may include the court’s ruling on subject matter jurisdiction related to foreign plaintiffs’ claims (particularly French plaintiffs), the court’s decision to include foreign investors in the class, and the method for calculation of damages. The parties will be paying close attention to the United States Supreme Court’s anticipated opinion in *Morrison v. National Australia Bank, Ltd.*, No. 08-1191, in which the Court will address whether and under what circumstances foreign-cubed class actions may be brought under U.S. securities laws.

#### CONCLUSION

*Vivendi* is only the ninth securities class action lawsuit tried to a verdict since passage of the PSLRA based on a company’s post-PSLRA conduct. Of these nine cases, after post-verdict motions and appeals, the verdicts favor defendants five to four. This nearly 50-50 split demonstrates why most securities class action cases do not go to trial, and why parties settle when they are unable to achieve an earlier dismissal – the uncertainty and potential liability are too great. Of course, when plaintiffs assert a multi-billion dollar claim, the parties may be unable to agree on a settlement figure. For Vivendi, the fight will likely continue on appeal, and it could be years before the matter is finally resolved and actual damages are determined.

## Sen. Dodd's Aiding and Abetting Amendment to Securities Laws Will Make Doing Business in the U.S. Even More Difficult

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In January 2008 the Supreme Court ruled that the “§10(b) implied private right of action does not extend to aiders and abettors.” *Stoneridge v. Scientific-Atlanta*, 552 US 148 (2008). Sen. Christopher J. Dodd (D-Conn.)’s recently introduced Restoring American Financial Stability Act of 2009 contains a provision hidden on page 795 of 1,136 that amends Section 21D of the Securities Exchange Act of 1934 (15 U.S.C. 78u-4) to overrule *Stoneridge*. It provides:

(g) PRIVATE CIVIL ACTIONS.—For purposes of any private civil action implied under this title, any person that knowingly or recklessly provides substantial assistance to another person in violation of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of this title to the same extent as the person to whom such assistance is provided.

The proposed amendment 15 U.S.C. 78u-4 would allow plaintiffs to pursue secondary actors such as accountants, underwriters, lawyers, customers, and suppliers **without having to prove they relied upon their statements or representations when purchasing or selling securities.**<sup>1</sup> The *Stoneridge* decision identified the reasons why eliminating reliance as an essential element of a private cause of action in order to create a private §10(b) cause of action for aiding and abetting is simply not a good idea. Dodd’s rejection of those reasons illustrates how destructive and dangerous the amendment would be to American business.

Stoneridge Investment Partners, LLC (Stoneridge) filed a class action on behalf of purchasers of stock in Charter Communications, Inc., a cable TV provider, seeking “to impose liability on entities who, acting both as customers and suppliers, agreed to arrangements that allowed the investors’ company to mislead its auditor and issue a misleading financial statement affecting the stock price,”<sup>2</sup> which is exactly what the Dodd amendment would do.

Stoneridge alleged that Scientific-Atlanta, Inc. and Motorola, Inc., Charter suppliers and customers, participated in a scheme by Charter to violate §10(b). Realizing that it would not meet its quarterly projections for cable subscriber growth and operat-

THE *STONERIDGE* DECISION IDENTIFIED THE REASONS WHY ELIMINATING RELIANCE AS AN ESSENTIAL ELEMENT OF A PRIVATE CAUSE OF ACTION IN ORDER TO CREATE A PRIVATE §10(B) CAUSE OF ACTION FOR AIDING AND ABETTING IS SIMPLY NOT A GOOD IDEA. DODD’S REJECTION OF THOSE REASONS ILLUSTRATES HOW DESTRUCTIVE AND DANGEROUS THE AMENDMENT WOULD BE TO AMERICAN BUSINESS.

ing cash flow, Charter allegedly arranged to overpay Scientific-Atlanta, Inc., and Motorola, Inc. for set-top boxes by \$20, which would be then returned to Charter as payments for advertising. Stoneridge alleged that Scientific-Atlanta, Inc., and Motorola, Inc. “knew or were in reckless disregard of Charter’s intention to use the transactions to inflate its revenues and knew the resulting financial statements issued by Charter would be relied upon by research analysts and investors.”

The district court dismissed the allegations for failure to state a claim on which relief can be granted. Concluding that the allegations failed to show that Scientific-Atlanta, Inc., and Motorola, Inc. made misstatements relied upon by the public or that they violated a duty to disclose, the Eighth Circuit affirmed. In a 5-3 majority opinion written by Justice Kennedy, the Supreme Court rejected the notion that Scientific-Atlanta, Inc. and Motorola, Inc.’s mere participation in Charter’s scheme violated §10(b).

The Supreme Court rejected Stonebridge's argument that the underlying scheme, itself, satisfied the required reliance element because in an efficient marketplace investors rely not just upon statements, but upon the transactions upon which the statements are based.<sup>3</sup> In rejecting the notion of "scheme liability" the *Stonebridge* court ruled that the §10(b) implied private right of action did not extend to aiders and abettors and that liability of secondary actors could only be based upon satisfying each element of a §10(b) claim, including reliance.

The reasons stated by the Supreme Court for requiring proof of reliance as a prerequisite for liability of secondary actors predict the following consequences if Dodd's amendment is enacted into law.

- Under Dodd's amendment, participation in transactions that underlie public statements can be the basis of a securities violation absent a public statement with the result that the implied cause of action for aiding and abetting will extend to the entire marketplace in which the issuing company does business.
- The amendment "would expose a new class of defendants" to the risk that plaintiffs with weak claims might use the expense of extensive discovery and the potential for uncertainty and disruption that accompany lawsuits to extort settlements from innocent companies identified by the court in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740-741 (1975).<sup>4</sup>

## Pepper Lawyers Speaking at New York Computer Forensics Show

Forensic Trade Shows, LLC and The New York Metro InfraGard are presenting the New York Computer Forensics Show on April 19-20, at the New York Convention Center. Pepper partners **Frank C. Razzano** and **Jeremy D. Frey** will be presenting a track on "Forensic Accounting: Intellectual Property Crimes." They will examine the various federal criminal laws which can be brought to bare on those violating the intellectual property of others.

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- mail and wire fraud prosecutions
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- It will raise the cost of doing business in the United States and could deter foreign companies from doing business in the United States.<sup>5</sup>

Given these significant, predictable consequences of Senator Dodd's amendment, one must question his judgment. Certainly, he is not committed to facilitating our country's economic recovery. Instead, he sees himself as a sort of new populist who in that tradition points his finger at bankers as the new enemy around which his constituency, he hopes, will rally.<sup>6</sup> But, in doing so, Dodd ignores what is best for business in the United States and its economy.

#### ENDNOTES

- 1 "In a typical § 10(b) private action a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation. *See Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341-342, 125 S. Ct. 1627, 161 L. Ed. 2d 577 (2005)." *Stoneridge*, 552 US at 157, n3.
- 2 *Stoneridge*, 552 US at 152-153.
- 3 *Id.* at 153-154.
- 4 *Id.* at 163-164.
- 5 *Id.* at 164.
- 6 As the *Wall Street Journal* noted, Sen. Dodd's aiding and abetting provision is a significant part of "Mr. Dodd's amazing 2010 election makeover from Wall Street's favorite Senator into the nation's leading banker baiter." In "Dodd's Lawsuit Makeover: Wall Street's favorite Senator goes populist," *WSJ.com*, 11.13.09.

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