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The Supreme Court's Decisions in Arthur Andersen and Dura Pharmaceuticals

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The Supreme Court's decisions in *Arthur Andersen* and *Dura Pharmaceuticals*

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In *Arthur Andersen LLP v. United States*, 125 S.Ct. 2129, a unanimous Supreme Court overturned an obstruction of justice conviction for Enron's chief auditor, Arthur Andersen. The accounting firm allegedly shredded documents during an ongoing SEC investigation in violation of 18 U.S.C. §§ 1512(b)(2)(A) and (B), which make it a crime for "Whoever knowingly uses intimidation or physical force, threatens, or corruptly persuades another person, or attempts to do so, or engages in misleading conduct toward another person, with intent to ... cause or induce any person to ... withhold testimony, or withhold a record, document, or other object, from an official proceeding [or] alter, destroy, mutilate, or conceal an object with intent to impair the object's integrity or availability for use in an official proceeding..."

In August of 2001, following the unexpected resignation of Enron's CEO, Jeffrey Skilling, and after an article appearing in the *Wall Street Journal* suggested improprieties at Enron, the SEC opened an informal investigation. By early September, Andersen formed an Enron "crisis-response" unit, which included Nancy Temple, an in-house counsel. Temple's notes during that time period indicated that "some SEC investigation" was "highly probable." On October 10, at a general meeting, an official for Andersen urged employees to comply with the company's document retention policy which stated that "in cases of threatened litigation, ... no related information will be destroyed." At the same meeting, however, employees were told "[I]f it's (a document) destroyed in the course of [the] normal policy and litigation is filed the next day, that's great ... [W]e've followed our own policy, and whatever there was that might have been of interest to somebody is gone and irretrievable."

Despite similar meetings reiterating compliance with the company's document retention policy, widespread destruction of documents continued. For example, on October 31, a day after the SEC had opened a formal investigation and requested Enron's accounting documents, the lead of Andersen's "engagement team" for Enron, David Duncan, destroyed a document labeled "smoking gun," commenting "we don't need this." According to the brief for the United States, Andersen permitted Enron to inflate earnings through accounting practices which were in clear violation of Generally Accepted Accounting Principles.

Subsequently, in March 2002, Andersen was indicted in the Southern District of Texas on a count of obstruction of justice. A jury later convicted. The instructions to the jury read, in part, "even if [petitioner] honestly and sincerely believed that its conduct was lawful, you may find [petitioner] guilty." The jury was told to convict if it found petitioner intended to "subvert, undermine, or impede" the SEC investigation by suggesting to its employees that they shred documents. The Court of Appeals for the Fifth Circuit affirmed.

In reversing the decision, Chief Justice Rehnquist opined that the jury instructions failed to convey the proper meaning of the statutory text, specifi-

IN THIS ISSUE

cally the terms "knowingly...corruptly persuade." He found the lack of culpability required in the instructions "striking," remarking that, with regard to similar statutory language, the Court had previously found that the mens rea "at least applies to the acts that immediately follow, if not to other elements down the statutory chain." Moreover, the Court held that the term "corruptly" had broader connotations beyond "subvert" or "undermine," noting that the term is normally associated with wrongful, depraved, or evil behavior. The Court also found error in the instructions failure to include any nexus requirement. By lacking a nexus element, the jury was wrongfully led to believe "that it did not have to find any nexus between the 'persuasion' to destroy documents and any particular proceeding." According to the Court, the statutory text mandates that the "official proceeding," in the very least, has to be foreseeable.

Despite the apparent malfeasance of Andersen in the Enron collapse, the Supreme Court's decision to reverse and remand was sound. The jury instructions securing the conviction were a veritable distortion of the statutory text. The instructions rendered the language in 18 U.S.C. §§ 1512(b)(2)(A) and (B) irrelevant, virtually making the shredding of documents a strict liability crime. And, in so doing the instruction failed to require the usual culpability needed in order to impose criminal liability.

In *Dura Pharmaceuticals, Inc., v. Broudo*, 125 S.Ct. 1627, the Supreme Court considered the heightened pleading requirements found in the Private Securities Litigation Reform Act of 1995 ("PSLRA") and the necessity for "loss causation." Congress passed the PSLRA in an effort to insulate corporations from expensive litigation which often arose following a decline in stock price. The perception was that many of the securities fraud claims were mere fishing expeditions, initiated in the hope that some impropriety would be found during the discovery stage.

Two salient features of the PSLRA have curbed, possibly over-curbed, potential securities fraud litigation. First, a safe harbor exists for any forward-looking statement made by a corporation or its executives. As a result, overstated growth and earnings projections often no longer serve as a basis for a lawsuit. The exact scope of the forward-looking safe harbor remains in question; however, recent cases brought before the 7th Circuit indicate a steady expansion of the safe harbor. Indeed, corporations appear able to escape liability by merely couching their words in the future tense.

Second, the PSLRA requires a plaintiff at the pleading stage to (1) identify each statement alleged to be misleading; (2) specify the reasons why the statement is misleading; and (3) "state with particularity all facts on which that belief is formed" if "an allegation regarding the statement or omission is made on information and belief." 15 U.S.C §78u-4(b). In addition, the plaintiff must allege with particularity sufficient facts creating a "strong inference" that the defendant acted with scienter, or an intent to deceive. As a result, and as *Dura* illustrates, potential 10b-5 securities fraud claims often do not survive a motion to dismiss.

In *Dura*, the respondents bought stock in Dura Pharmaceutical between April 15th, 1997, and February 24, 1998. During this period, Dura allegedly made false statements concerning both its drug profits and future FDA approval of a new asthmatic spray device. On the last day of the purchase period, Dura announced a reduction in earnings and the stock fell precipitously from $39 per share to about $21. In November of 1998, Dura announced that the FDA would not approve Dura's new asthmatic spray device. The next day Dura's share price temporarily fell but almost fully recovered within one week.

Shortly after, investors brought a 10b-5 action against Dura before the 9th Circuit. Rule 10b-5 forbids, in part, the making of any "untrue statement of material fact" or the omission of any material fact "necessary in order to make the statements made ... not misleading." The District Court dismissed the complaint. In respect to the plaintiffs' drug-profitability claim, it held that the complaint failed adequately to allege an appropriate state of mind. As to the plaintiffs' spray device claim, the court found that the complaint failed adequately to allege "loss causation." With respect to the latter claim, the Court of Appeals for the Ninth Circuit reversed, holding that the "plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation."

In reversing the 9th Circuit, the Supreme Court found that the plaintiffs did not establish loss causation by simply alleging price inflation. Loss causation is the causal connection between the material misrepresentation and the loss. Or, in other words, plaintiffs must establish that the misrepresentation was the proximate cause of their loss. The Court found that the 9th Circuit's formulation eliminated the proximate cause element from a 10b-5 cause of action, stating that when a purchaser later resells shares at a lower price "that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances..." Thus, an initially inflated purchase price "might" mean a subsequent loss, but price inflation alone does not establish proximate cause given the various factors affecting price.

As a result, the Court held that the plaintiffs' complaint failed adequately to allege the proximate cause requirement. The Court dismissed the complaint, even while assuming for argument sake that the PSLRA does not impose any special further pleading requirement with respect to damages, beyond what is already required by the Federal Rules of Civil Procedure.

The Court's holding that plaintiff must prove loss causation, at first blush, does not seem that extraordinary. Many practitioners believe that Broudo will simply amend his complaint to allege loss causation.

However, there are suggestions in the Court's opinion that could prove troubling. The Court stated:

> The complaint's failure to claim that Dura's share price fell significantly after the truth became known suggests that the plaintiffs considered the allegation of purchase price inflation alone sufficient. The complaint contains nothing that suggests otherwise.

The intimation from the above is that, since the price fell substantially after the profit disclosure but not after the spray device disclosure, there were no damages arising from the spray device misrepresentation. Were courts to so hold, this would be unfortunate.

It is likely that both misrepresentations contributed to the inflated price. The psychology of the market is that, when the enthusiasm bubble is burst by one disclosure of corporate maldisclosure, the price will fall significantly because other prior favorable disclosures will be discounted due to the company's credibility gap. If courts do not recognize this, courts will encourage a corporate policy of serial disclosure.

For example, if one misrepresentation in *Dura* dealt with forward looking information and another dealt with factual information, the company would be motivated to correct the profitability forecasts in the forward looking statement and let the price drop. It would then correct the factual information. Because of the PLSRA safe harbor for the forward looking information, there would be no liability for the forward looking misrepresentation. Moreover, there would be no damages for the factual misrepresentation because, if these were no farther price drop, under an extension of *Dura*, there would be no loss causation.

The fallacy in this approach is that it assumes that the market separately and specifically values each bit of information and that such increments of value are determinable When a company makes a series of misstatements that affect market price, it should not be able to game the system and escape all liability by first disclosing adverse news protected by a safe harbor and then claiming that other maldisclosures had no effect on value.

Owners and operators of ATMs take notice or pay the price for Automated Terrible Misfortune

By Adam C. Toosley, A. Jay Goldstein, and Denean K. Sturino

Introduction

The banking industry, not unlike every other major industry in the world, has steadily progressed into becoming a virtual electronic industry. A large part of the electronic transition was the implementation and influx of automated teller machines ("ATMs"). According to one report, there are over 1.2 million ATMs in the world, and over 300,000 ATMs in the United States. What many ATM operators don't know, but are now realizing, is that an amendment to the Electronic Funds Transfer Act (the "EFTA") has provided savvy consumers with an opening to bring a new type of lawsuit based on the ATM operators' oversight. Don't lose sleep just yet, as ATMs need to have dual proper notices of any transaction fees. ATM operators and financial institutions can implement simple measures to prevent such costly litigation and the payment of significant monetary damages.

Background of the EFTA and Regulation E

In 1978, the United States passed the EFTA.[1] The primary objectives of the EFTA are the "protection of individual consumers engaging in electronic fund transfers"[2] and to provide "safeguards in electronic fund transfer systems."[3] The EFTA was put into regulation format in what is known as Regulation E in the Code of Federal Regulations.[4]

As part of the EFTA, all ATM operators who charge a fee for a transaction at the ATM are responsible for placing notice in two places pertaining to the fee that the ATM operator intends to collect.[5] ATM operators are required to maintain a notice on the outside of an

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