NYSBA SUMMER 2012 | VOL. 16 | NO. 1

NY Business Law Journal

A publication of the Business Law Section
of the New York State Bar Association

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A Tale of Two Judges

By C. Evan Stewart

Someone once wrote: "[i]t was the best of times, it was the worst of times...."[1] Many people might say that that sentiment captures our current times pretty well. Events involving two well-known federal judges might make the legal highlights film for that conflicted proposition, and they have some important take-homes for all of us.

Judge Kaplan and the Department of Justice

The issue of cooperation with the government (a/k/a the "800 pound gorilla") has been with us for some time.[2] The perception (and reality) has been that under-investigation companies, attempting to curry favor with the government, would do almost *anything* to have the government call off the dogs.

This situation arguably reached its pinnacle (or nadir) in *United States v. Stein*.[3] In *Stein*, KPMG—one of the country's largest accounting firms—was attempting to avoid indictment by the federal government; having seen what happened to competitor Arthur Andersen only a few years before, this was not an irrational business judgment.[4] At that time, the Justice Department had in effect a 2003 memorandum issued by then-Deputy Attorney General Larry Thompson. The Thompson memorandum had been issued to give guidance to corporations under the government's gun as to what the DOJ would consider constituting "cooperation," and through such "cooperation," corporations could hope for more lenient treatment. Two of the more controversial components of the Thompson memorandum were: (1) corporate "cooperation" with the government would be favorably judged if companies waived the attorney-client privilege (and other applicable privileges); and (2) said "cooperation" would also be favorably judged if companies forwent the advancement of attorneys' fees for employees targeted by the government (notwithstanding corporate by-laws either mandating or allowing for attorneys' fees to be advanced).[5]

For KPMG, waiving any and all privileges and giving up materials to the U.S. Attorney's office was a no-brainer. Harder was the decision-making process regarding the thirteen former partners and employees of the firm who were individual targets. All thirteen had retained skilled (and expensive) counsel based upon KPMG's time-honored practice of advancing attorneys' fees to its current and former employees with respect to job-related conduct. But after some very significant jaw-boning by two Assistant U.S. Attorneys, the company threw its former (now indicted) colleagues under the bus and shut off the money spigot.

After the indictments were handed down, the individual defendants moved before Judge Kaplan to dismiss the indictments based upon the government's interference with KPMG's advancement of fees. The Judge then held an extensive evidentiary hearing to determine the government's role in KPMG's decision vis-à-vis the advancing of fees. Based upon that hearing, Judge Kaplan ruled (1) that the defendants had a fundamental right under the Fifth Amendment to fairness in the criminal process (including the right to get all "resources lawfully available to him or her [without] government interference");[6] and (2) that the defendants' Sixth Amendment rights (to choose the lawyer he or she desires) had been violated by the government's conduct. Ultimately, finding that the prosecutors' conduct "independently shock[s] the conscience" (so much so, that he singled out and referenced the Assistant U.S. Attorneys by name), Judge Kaplan dismissed the indictments because there was no alternative remedy that would put the defendants in the position they would have been, "but for" the government's misconduct.[7]

The government appealed the dismissal of the indictments. At this point I must admit I was unsure as to what would happen in the Second Circuit. On the one hand, what the government had done was truly shocking and wrong.[8] But the problem was that KPMG was not a public corporation with corporate by-law or statutory obligations; instead, it was a private partnership in which the advancement history was merely a time-honored practice, not something whereby you could point to a legal obligation mandating advancement.[9] Perhaps this would be the unusual case where a wrong had no remedy?

The Second Circuit affirmed Judge Kaplan,[10] but to reach that result they chose an unusual route. Making extensive use of the factual findings made by the lower court (i.e., the government **made** KPMG do it)—which the Second Circuit panel was of the view it was not empowered to challenge or overturn,[11] the Court of Appeals ruled that the Sixth Amendment rights of the individual defendants had been violated and that Judge Kaplan's remedy was appropriate. Since the Court of Appeals could not look to corporate by-laws or state law requiring advancement of fees, the Second Circuit based its analysis and ruling on the doctrine of state action.

As the Second Circuit acknowledged, the jurisprudence of state action "'ha[s] not been a model of consistency.'"[12] And it then went on to show why. First off, it opined that to wrap up a private entity (i.e., KPMG) as an instrumentality of the government, it must be "'operat[ing] as a *willful participant* in joint activity' with the government...."[13] The notion that KPMG—faced with a possible criminal indictment—was a "willful participant" with the government is, of course, absurd; the accounting firm was about as adversarial to the government as possible, and it caved into the pressure from the two Assistant U.S. Attorneys only under extreme duress.

And besides overcoming that bizarre legal and factual situation, the Second Circuit also had to deal with its own precedent to the contrary. In *D.L. Cromwell Investments, Inc. v. NASD Regulation, Inc.*,[14] the Court of Appeals affirmed a decision by Judge Kaplan, which involved parallel investigations being conducted by the DOJ and the NASD (the forerunner of FINRA) where the NASD lawyers were working with their DOJ counterparts and receiving information that was helping their investigation. Four brokers, who were also targets of the DOJ, sought to enjoin the NASD from compelling their testimony for fear it would be used by the DOJ.[15] Judge Kaplan ruled (and the Second Circuit agreed) that there would be no Fifth Amendment problem because the NASD is/was not a government entity, and thus the doctrine of state action would not be implicated. Huh? The two entities were not only indisputably working together "willful[ly]" in parallel investigations (and sharing information), but the NASD was a quasi-governmental entity (as is FINRA), specifically regulated by the Securities and Exchange Commission pursuant to the Securities Exchange Act of 1934. While "foolish consistency [may be] the hobgoblin of little minds,"[16] the Second Circuit in *Cromwell* found no state action, where there was state action; and in *KPMG*, the court found state action, where there was no state action.

What should we make of these rather hard to rationalize judicial rulings? One man's perspective is that the *Cromwell* situation probably did not seem to Judge Kaplan and the Second Circuit as being enough of a big deal (and both courts likely expected NASD lawyers would be more careful (or at least more circumspect) going forward with respect to information sharing in parallel investigations).[17] As to the *KPMG* situation, however, the two courts seemed to have been genuinely concerned about extreme overreaching by the government and, in particular, by the two Assistant U.S. Attorneys—both of whom were repeatedly identified by name in the two opinions.[18] The naming of those lawyers, I believe, had as much of an impact on the Justice Department ultimately tweaking the Thompson memorandum (to remove affirmative "requests" for privilege waivers and denials of advancement), as did the substantive decisions by Judge Kaplan and the Second Circuit.[19] In the end, and irrespective of judicial inconsistencies, it is heartening that the Judicial Branch stands ready to stare down the Executive Branch when it goes too far and threatens important individual liberties (i.e., the ability of individuals to defend themselves against the overwhelming power of the government).[20]

Judge Rakoff and the Securities and Exchange Commission

For what seems like an eternity, the Securities and Exchange Commission has regularly entered into settlements with corporations, with such settlements having as their centerpieces (i) the corporations neither admitting nor denying liability, and (ii) the SEC asking a federal district court judge to impose his or her imprimatur on the settlement, thereby getting an injunction against future violations of the law. The first centerpiece has traditionally been justified on two grounds: first, that it saves the SEC resources by not having to litigate and prove wrongdoing at trial; and second, that it allows corporations the ability thereafter to litigate trail-along civil litigation brought by private plaintiffs (and the plaintiffs' bar). The second centerpiece is more of a historical artifact: it dates back several decades to when the SEC had very few weapons in its enforcement arsenal to penalize and deter corporate wrongdoing.

I thought that at least part of this settlement pattern was going to be affected when Judge Rakoff rejected a $33 million settlement between the SEC and Bank of America. According to the SEC, Bank of America had "materially lied" to Bank of America shareholders by failing to disclose, prior to a December 5, 2008 vote on Bank of America's proposed acquisition of Merrill Lynch, that $5.8 billion in bonuses were going to be paid to Merrill Lynch employees. In rejecting that settlement, Judge Rakoff opined that it did "not comport with the most elementary notions of justice and morality." Upset that Bank of America shareholders were both victimized and were also being made to bear the financial penalty for the alleged misconduct, the Judge ruled that the settlement was merely "a contrivance designed to provide the SEC with the façade of enforcement and the management of the bank with a quiet resolution of an embarrassing inquiry." Ultimately, and only grudgingly (and only after Bank of America had turned itself inside-out to meet the Judge's demands),[21] Judge Rakoff approved a $150 million settlement which hardly seemed like an SEC triumph.[22]

After the SEC was put through that difficult gauntlet, I thought there were two alternative ways to handle such matters going forward: either the SEC would utilize its administrative proceedings to effect the same settlements (and thus avoid the scrutiny of Article III judges), or the SEC would continue to seek such scrutiny in order to be able to invoke federal courts' contempt powers.[23] The SEC, for some reason, chose the latter.

Fast forward to March of 2011, when the SEC again found itself before Judge Rakoff with a settlement he found less than compelling.[24] Although Judge Rakoff decided to approve the settlement (largely because two of the individuals involved had pleaded guilty to related criminal charges and the company, despite being destitute, had paid a multimillion dollar penalty),[25] he opined that the "disservice to the public interest in such a [settlement] practice is palpable."[26] More generally, Judge Rakoff decried the SEC's seeking a federal court's imprimatur on such settlements, tracing the rationale for that protocol back to the above-referenced era when the Commission's enforcement powers were limited; the SEC's current enforcement powers are now both wide and deep (which they can invoke without ever having to go to court).

With that past as prologue, the SEC went for a trifecta in October of 2011, filing a complaint in federal court in New York, charging Citigroup with securities fraud in connection with a synthetic collateralized debt obligation ("CDO") it

sold to investors in 2007. Simultaneous with the court filing, the SEC: (i) announced it was settling the matter with Citigroup for $285 million; (ii) filed a separate lawsuit against a former Citigroup employee it claimed was the principal individual responsible for the CDO fraud; and (iii) instituted settled administrative proceedings against two Credit Suisse entities and a Credit Suisse employee for their roles in the CDO transaction.[27] The judge who drew the task of overseeing and approving the SEC's settlement with Citigroup: Judge Rakoff.

At the same time the SEC was going public with its spin on the resolution of this allegedly fraudulent securities transaction, Citigroup issued its own press release. On top of the settlement tracking the traditional mantra of neither admitting nor denying wrongdoing, Citigroup highlighted for the investing public the fact that the SEC had not charged the company with "intentional or reckless misconduct."

Perhaps in response to these public releases ("How can a securities fraud of this nature and magnitude be the result simply of negligence?"), Judge Rakoff scheduled a settlement hearing, in advance of which he asked the settling parties to answer nine questions relating to whether the settlement was "fair, adequate, and reasonable." Not satisfied with the answers he received, Judge Rakoff rejected the settlement, a rejection that has been appealed by both the SEC and Citigroup.

Since the appeal was lodged to the Second Circuit, a few things have happened. First was the "dramatic" announcement by the SEC that it was changing its policy on neither admitting nor denying liability;[28] this policy change, however, was much ado about nothing—now, firms pleading guilty to *criminal* felonies will no longer be allowed to agree to *civil* settlements in which they neither admit nor deny *civil* liability. Next up, an enterprising *New York Times* reporter revealed that, over a decade-long period, the SEC has given 350 waivers to financial institutions that have existing injunctions not to commit securities fraud again;[29] in other words, the contempt "teeth" sought by the SEC in going to a federal judge to approve settlements has simply not been used to restrain or punish corporate recidivism. Third, by increasing numbers, more federal judges have started to follow Judge Rakoff's lead in questioning civil settlements brought for their approval by the federal government.[30] But then, just as suddenly, a Second Circuit panel, ruling on the SEC's motion for a stay of the Citigroup proceedings before Judge Rakoff pending its (and Citigroup's) appeal, granted that motion in light of the SEC's "strong likelihood of success" in demonstrating that the settlement was not "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law."[31]

So, what is there to be learned from Judge Rakoff's face-off with the SEC? As an initial matter, while it would appear likely that the Second Circuit will reverse his rejection of the Citigroup settlement, do not place *all* of your chips on that bet in Vegas.[32] There are at least four ways the Court of Appeals could approach this case (and the Court could mix and match): first, it could agree with Judge Rakoff's threshold complaint—that the SEC need not be bringing each and every settlement into federal district court, especially given the indisputable fact that the Commission never seems to invoke the injunctive power it is so eager to engraft as part of these settlements; second, it could agree with Judge Rakoff's second point—that if the SEC is going to come into federal district court, then the judge is not to be a mere "potted plant," but is instead supposed to exercise his or her judgment in assessing whether the settlement is appropriate; third, assuming the Second Circuit takes that second step, hopefully the Court would then articulate some constructive guidelines to help all concerned (i.e., the SEC, corporations, judges) understand how settlements will be reviewed; and finally, it seems likely that the Second Circuit will ultimately rule that Judge Rakoff went a bridge too far in criticizing and rejecting the SEC's policy of neither admitting nor denying liability—in its initial ruling on the motion for a stay, the Second Circuit (correctly, I believe) made it clear that such a policy is properly within the province of the Executive Branch, and the Judicial Branch does not have a role in passing judgment on the wisdom of the Executive Branch's decision-making in that realm.

If the Second Circuit does some or all of the foregoing, will that curb the growing appetite of federal district judges to question governmental settlements? My guess would be: probably yes. But such an outcome will not, I hope, curb federal judges from stepping in to restrain the 800-pound gorilla when and where such intervention is appropriate.

In fact, Judge Rakoff, even with the pendency of the Citigroup appeal hanging over him, has shown that he has not lost any of his courage in this regard. In the insider trading case brought by the government against Rajat Gupta,[33] Judge Rakoff issued a most important pre-trial ruling that will have a significant impact going forward on parallel investigations undertaken by the DOJ and the SEC. On Mr. Gupta's motion, the Judge ruled that joint interviews conducted by DOJ and SEC lawyers—and memoranda created by *both* sets of lawyers thereafter—were subject to the government's *Brady* obligations;[34] thus, all exculpatory evidence was required to be turned over from all of those sources (i.e., it could not be hidden in the SEC work papers). This bold and common-sense ruling is certainly a good thing for all citizens who want a level playing field when faced with the 800 pound gorilla.

Conclusion

We give Article III judges not only enormous power, but also lifetime tenure. And while that can sometimes lead to excesses, in the hands of intelligent and courageous men and women that power can help protect our liberties. Whether one agrees completely or even partially with the actions of Messrs. Kaplan and Rakoff, we are lucky that those men have committed their lives to public service.

Endnotes

1. *See* Charles Dickens, A Tale of Two Cities 1 (Andrew Sanders, ed., Oxford University Press 1990) (1859). There have been at least five movies based upon Dickens' classic work, the most famous of which is the 1935 MGM production, starring Ronald Colman (the film was nominated for an Oscar for Best Picture). Star Trek II: The Wrath of Khan (Paramount Pictures1982) pays homage to the book, with Spock (Leonard Nimoy) sacrificing his life to save the USS Enterprise.
2. *See, e.g.*, C. Evan Stewart, *The False Promise of 'Reform,'* N.Y.L.J. (2008); C. Evan Stewart, *'Carnacking' the Future*, N.Y.L.J. (2007); C. Evan Stewart, *When the Government Comes Knocking*, N.Y.L.J. (2005).
3. United States v. Stein, 435 F. Supp. 2d 330 (S.D.N.Y. 2006), *aff'd*, 541 F.3d 130 (2d Cir. 2008) (*"Stein I"*); *see also* United States v. Stein, 495 F. Supp. 2d 390 (S.D.N.Y. 2007) (*"Stein IV"*); United States v. Stein, 452 F. Supp. 2d 230 (S.D.N.Y. 2006), *vacated sub nom.*, Stein v. KPMG, LLP, 486 F.3d 753 (2d Cir. 2007) (*"Stein III"*); United States v. Stein, 440 F. Supp. 2d 315 (S.D.N.Y. 2006) (*"Stein II"*).
4. *See* C. Evan Stewart, *The Post-Enron Pendulum: Is It Swinging Back (and in What Direction)?*, Am. Banker (2005); C. Evan Stewart, *The Ethics of Document Destruction: Andersen Agonistes*, N.Y.L.J. (2002).
5. *See* Del. Code Ann. tit. 8, § 145 (2012).
6. *Stein I*, 435 F. Supp. 2d at 361.
7. *Stein IV*, 495 F. Supp. 2d at 412, 419–28.
8. Having had one client go up against the New York Attorney General, who attempted to shut down the advancement of fees (happily, unsuccessfully), I believe the government's attempt to deny citizens the right to defend themselves in criminal trials to be downright un-American. *See When the Government Comes Knocking*, *supra* note 2.
9. *See* tit. 8, § 145.
10. United States v. Stein, 541 F.3d 130, 136 (2d Cir. 2008).
11. *Id.* at 142–44.
12. *Id.* at 147 (quoting Edmonson v. Leesville Concrete Co., 500 U.S. 614, 632 (1992) (O'Connor, J., dissenting)).
13. *Id.* at 147 (emphasis added) (quoting Flagg v. Yonkers Sav. & Loan Ass'n, 396 F.3d 178, 187 (2d Cir. 2005).
14. D.L. Cromwell Investments, Inc. v. NASD Regulation, Inc., 279 F.3d 155 (2d Cir. 2002), *aff'g* 132 F. Supp. 2d 248 (S.D.N.Y. 2001).
15. As a practical matter, individuals subject to an NASD/FINRA investigation do not have Fifth Amendment rights because, if they invoke that Constitutional right, FINRA (as did the NASD) will ensure that they are barred from the securities industry.
16. *See* Bartlett's Familiar Quotations 606 (14th ed. 1968) (quoting Ralph Waldo Emerson).
17. Whether or not that has been true is open to question. *See* U.S. v. Stringer, 408 F. Supp. 2d 1083 (D. Or. 2006), *rev'd*, 521 F.3d 1189 (9th Cir. 2008).
18. The U.S. Attorney had petitioned Judge Kaplan to delete their names from his initial decision; he specifically refused to do so.
19. *See Carnacking the Future*, *supra* note 2. It is indeed only "tweaking" because corporations that reach these decisions "on their own" are still eligible for more lenient treatment.
20. And while the DOJ has "tweaked" the Thompson memorandum slightly (its successor is named after Paul McNulty, Mr. Thompson's successor), that has not stopped the DOJ from envelope-pushing prosecutions, *see* C. Evan Stewart, *Corporate Criminal Liability Run Amok*, N.Y.L.J. (Nov. 15, 2007), or the SEC from bringing astonishing cases against those folks most beloved by readers of this journal—i.e., lawyers. *See, e.g.*, *In re John E. Isselmann, Jr., Litigation Release No. 18896*, Securities and Exchange Commission,Sept. 23, 2004, http://www.sec.gov/litigation/litreleases/lr18896.htm (last accessed Apr. 26, 2012; *In re Jordan H. Mintz, Litigation Release No. 59296*, Securities And Exchange Commission, Jan. 26, 2009, http://www.sec.gov/litigation/admin/2009/34-59296.pdf (last accessed Apr. 26, 2012); *In re Rex. R. Rogers, Litigation Release No. 59297*, Securities and Exchange Commission, Jan. 26, 2009, http://www.sec.gov/litigation/admin/2009/34-59297.pdf (last accessed Apr. 26, 2012).
21. *See* C.E. Stewart, *Pandora's Box and the Bank of America*, N.Y.L.J., (Nov. 4, 2009).
22. *See* J. Coffee, *Illusory Victories?: Do SEC Settlements Deter?*, N.Y.L.J. (Nov. 18, 2010) (the SEC/Bank of America settlement "caused reputational harm").
23. *See* Stewart, *supra* note 21.
24. SEC v. Vitesse Semiconductor Corp., 771 F.Supp.2d 304 (S.D.N.Y. 2011).
25. As such, Judge Rakoff, citing the case's "unusual circumstances," decided to reserve "for the future substantial questions of whether the Court can approve other settlements that involve the practice of 'neither admitting nor denying.'" *Id.* at 310.
26. Judge Rakoff further opined that the practice creates "a stew of confusion and hypocrisy unworthy of such a proud agency as the SEC," and that "only one thing is certain: the public will never know whether the SEC's charges are true, at least not in a way that they can take as established by these proceedings." *Id.* at 309.
27. *See In re Brian H. Stoker, Litigation Release No. 22134*, Securities and Exchange Commission, October 19, 2011, http://www.sec.gov/litigation/litreleases/2011/lr22134.htm (last accessed May 1, 2012). (The Credit Suisse entities paid $2.5 million in disgorged fees and penalties; the individual was suspended from the securities industry for six months.).
28. *See* E. Wyatt, *S.E.C. Changes Policy on Firms' Admission of Guilt*, New York Times B1 (January 7, 2012) http://www.nytimes.com/2012/01/07/business/sec-to-change-policy-on-companies-admission-of-guilt.html (last accessed May 1, 2012).
29. *See* E. Wyatt, *S.E.C. Is Avoiding Tough Sanctions For Large Banks*, New York Times 1 (February 3, 2012) http://www.nytimes.com/2012/02/03/business/sec-is-avoiding-tough-sanctions-for-large-banks.html?pagewanted=all (last accessed May 1, 2012).
30. *See* E. Wyatt, *Settlements Without Admissions Get Scrutiny*, New York Times B1 (February 25, 2012) http://www.nytimes.com/2012/02/25/business/neither-admit-nor-deny-settlements-draw-judges-scrutiny.html (last accessed May 1, 2012); SEC v. Koss Corp., No. 11 Civ. 00991 (RTR) (E.D. Wis. December 20, 2011).
31. SEC v. Citigroup Global Markets Inc., No. 11-5227 (2d Cir. March 15, 2012). *See Evaluating SEC Non-Prosecution and Deferred Prosecution Agreements*, 44 Sec. Reg. & L. Rep. (BNA) 666 (April 2, 2012).
32. The Second Circuit, in appointing counsel to represent Judge Rakoff on the appeal, obviously recognizes that this case presents numerous and complex issues. *See Group, Citing 'Good Cause,' Asks Again for Enhanced Role in SEC/CitiGroup Case*, 44 Sec. Reg. & L. Rep. (BNA) 710 (April 9, 2012). With oral argument set for the latter half of September (*see SEC, Citing 2d Circuit Order, Asks Court to Approve Deal with Bear Stearns Execs*, 44 Sec. Reg. & L. Rep. (BNA) 604 (March 26, 2012)), much of what is set forth above may be moot (to the nth degree) as of the time this is being read. Nonetheless, I stand by the comments expressed above, whether or not my Nostradamus skills are vindicated.
33. This case is highlighted in C. Evan Stewart, *The SEC and Litigation: Oil and Water?*, N.Y.L.J. (November 8, 2011).
34. Brady v. Maryland, 373 U.S. 83 (1963). *See SEC OCIE Chief Outlines Plan to Tackle Private Fund Advisers*, 44 Sec. Reg. & L. Rep. (BNA) 561 (March 19, 2012).