

## FROM CORRUPTION TO COURTROOM: THE MANY ROADS

### INTRODUCTION

Corporate executives and directors accused of wrongdoing can be exposed to greater consequences than might sometimes be assumed. This issue of CUG.COMments takes a brief look at the possible judicial events that can follow allegations of inappropriate behavior. Note: the extent to which insurance coverage is provided for any of the following circumstances depends on the specifics of the policies issued and the extent to which insurance is permitted by law.

#### A. CIVIL PROCEEDINGS

##### 1. *Federal Securities Class Action Lawsuits*

The traditional response to alleged corporate malfeasance, these lawsuits are filed by a group of investors, known as a class, who believe that wrongful acts by corporate executives have caused financial loss to the members of the class. The class action format developed as the most efficient, if not necessarily the most effective, method of combining into one manageable action what might otherwise be thousands of individual lawsuits. Securities class action (SCA) lawsuits are civil actions alleging violations of federal securities laws dating from 1933 and 1934. At one time SCA lawsuits could be brought in either state or federal court, however the Securities Litigation Uniform Standards Act of 1998 (SLUSA) fol-

lowed by a clarifying Supreme Court decision in 2006 [*Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit* 547 U.S. \_\_ (2006)] have pushed SCA lawsuits almost exclusively to the federal court system.

After being granted "class status" by meeting certain prerequisites and criteria under the Federal Rules of Civil Procedure, an SCA suit typically has to survive a motion to dismiss filed by the defendants. If the motion is denied the lawsuit will proceed to the discovery phase, where the parties exchange documents and conduct depositions to obtain information, and then to trial. However, in practice most cases settle before reaching trial.

##### *Resources:*

<http://securities.stanford.edu/>  
<http://www.law.cornell.edu/rules/frcp/Rule23.htm>

##### 2. *"Opt-Out" Lawsuits*

For most individual investors the class action vehicle, while far from ideal, remains the only practical way to pursue a securities-related grievance against a company and its executives and directors. However, large institutional investors with significant resources may decide not to join the class action and instead "opt-out." This leaves them free to pursue their case separately, often in the state court system. Instances of opt-outs are increasing and so present an additional area of concern (and expense) for defendants.

Resource:

[http://www.businessweek.com/magazine/content/06\\_09/b3973059.htm?chan=search](http://www.businessweek.com/magazine/content/06_09/b3973059.htm?chan=search)

### 3. *Derivative Lawsuits*

Securities class action lawsuits and any opt-outs they may spawn involve investors seeking compensation for losses they allegedly sustained on their own account. A derivative lawsuit is typically commenced by disgruntled shareholders who do not seek compensation for themselves but for the corporate entity. Such suits are therefore brought on behalf of the corporation and usually allege impairment in the corporation's value due to the actions of the executives or directors.

Amounts awarded in derivative lawsuits have tended to be lower than those in SCA lawsuits, however the trend is for more frequent derivative actions seeking higher damages. Derivative suits are typically brought in state court, often in Delaware which for many corporations is their state of incorporation. Because derivative suits often follow on the heels of an SCA lawsuit they are sometimes called "tag-along" suits, although stand-alone derivative actions can be brought.

Resource:

<http://www.baileycavalieri.com/CM/Articles/BAILEY-D&O%20Derivative%20Suits%2011-9.pdf>

### 4. *SEC Actions*

The Securities and Exchange Commission (SEC) is a federal agency whose general mission is to protect investors against violations of the federal securities laws. Its roles include that of rule maker, regulator, policeman and if necessary, civil prosecutor. The SEC keeps a close watch for transgressions of the securities laws; if it believes warranted, it will bring a civil action seeking restitution, fines and other penalties from the targeted defendants. It may also recommend to the

federal Department of Justice that it should pursue a criminal prosecution. SEC civil actions are typically brought in the federal court system.

Resource:

<http://www.sec.gov/divisions/enforce.shtml>

## B. CRIMINAL PROCEEDINGS

### 1. *Federal Department of Justice Proceedings*

Alleged violations of federal securities acts and other anti-fraud laws are not only cause for civil proceedings. If the actions are deemed serious enough, federal prosecutors can seek a criminal indictment. Such cases are prosecuted in the criminal courts in the appropriate federal district and if successful can result in long prison sentences.

It is the threat of criminal prosecution that has probably attracted the most attention. Recent sentences of convicted executives such as Bernard J. Ebbers, former CEO of WorldCom (25 years imprisonment) and Jeffery K. Skilling, former CEO of Enron (24 years imprisonment) reveal the federal authorities' determination to find and punish perpetrators. Federal sentencing guidelines have called for stiffer penalties and there is no parole in the federal criminal system: early release for good behavior is possible but is limited to a maximum of 54 days per year. In other words, 85% of the sentence must typically be served.

This prosecutorial zeal arguably dates back to 2002 with the formation of the federal Corporate Fraud Task Force, an interagency group that includes the Department of Justice, the Chairman of the SEC and the Secretary of the Treasury.

Resource:

<http://www.usdoj.gov/dag/cftf/>

## 2. State Criminal Prosecutions

**B**ecause alleged crimes related to securities often violate federal acts, the federal forum is the natural place for them to be tried. However, fraud is also a crime in every state and states' attorneys general or other state prosecutors are not constrained in their ability to prosecute what they see as criminal fraud against the citizens of their state. This means that occasionally a state attorney general will decide (for reasons that may be complex) to assert the state's right to bring a criminal action against individuals accused of corporate wrongdoing.

Resource:

<http://ag.ca.gov/newsalerts/release.php?id=1378&year=2006&month=9&endMonth=11&endYear=&PHPSESSID=fe1204695c213a462bf4d76f6f8e5dc7>

## C. THE INTERNAL REVENUE SERVICE

**O**n top of shareholder, regulatory and criminal proceedings, the hapless defendant may face investigation by the Internal Revenue Service (IRS) which may be waiting in the wings to see how the various allegations develop regarding improper tax avoidance or illegal tax evasion. The IRS can initiate criminal proceedings that could result in prison time for the accused and also press for civil enforcement that seeks financial restitution and penalties.

Resource:

<http://www.irs.gov/compliance/enforcement>

### SUMMARY

**A**lleged violators of securities acts and alleged committers of fraud can face a daunting array of private and public antagonists seeking to deprive the defendants of their money and possibly their liberty. The greater the extent and magnitude of the alleged wrongdoing, the greater is the attention that will be attracted. ❖

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