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Securities Enforcement in 2005: The Year in Review

By James A. Meyers

This past year was one of transition and of numerous important court decisions and enforcement actions. This article summarizes the major enforcement news of 2005, beginning with criminal enforcement, then moving on to SEC enforcement and litigation, followed by a look at the numerous personnel departures and arrivals at the SEC and their impact on enforcement, and concluding with a look at what the future may hold in 2006.

Securities Enforcement in Brief

Several criminal cases went to trial, with mixed results. Bernard Ebbers, Dennis Kozlowski, and Mark Swartz were convicted, and all received significant sentences, as did John and Timothy Rigas following their 2004 convictions. However, Richard Scrushy and Richard Hawkins were acquitted in federal trials, and Theodore Sihpol III was acquitted in a securities fraud trial brought by Eliot Spitzer.

The SEC settled numerous large financial fraud and mutual fund market timing and late trading investigations. It also brought several actions against "gatekeepers," following through on a commitment made by then-Enforcement Director Stephen Cutler in a September 2004 speech. And it brought a number of actions involving hedge funds, executive compensation, the Foreign Corrupt Practices Act, 529 college savings plans, and self-regulatory organizations, perhaps presaging its 2006 enforcement agenda.

The SEC's record in civil litigation was mixed. The agency achieved an important victory from the

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Scheme Liability for Secondary Actors in Public Statement Cases

By Koji F. Fukumura and Aaron F. Olsen

In 1994, the U.S. Supreme Court seemingly settled the issue of when "secondary actors" could be held liable for securities fraud claims. The Supreme Court held that private plaintiffs cannot bring a claim for "aiding and abetting" under section 10(b) of the Securities Exchange Act of 1934. However, the Supreme Court explained that secondary actors can be held liable to the extent that they are primary violators of the securities laws. Not surprisingly, the plaintiffs' class action bar responded by characterizing secondary actors as primary violators. These secondary actors, however, typically have made no statements to the investing public. Thus, plaintiffs usually failed to plead adequately a claim under Rule 10b-5(b) against the secondary actors in cases involving allegedly false or misleading financial statements.

Now, in light of the recent wave of public company accounting scandals, plaintiffs are pursuing claims against secondary actors in public statement cases by arguing that—even if the secondary actor did not make "the" public statement—he

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Mediation of Securities Disputes: Views from the Advocate and the Mediator

By John S. Monical and Kent Lawrence

The United States has seen a steady and accelerating trend toward formal mediation in connection with both court and arbitral dispute resolution. Statistics from the NASD Dispute Resolution, Inc. (the NASD) are indicative of the broader trends in mediation. While settlement rates through mediation have remained consistent (around 80–85 percent), the use of mediation has expanded. The cases closed through the NASD mediation program have grown from only 211 cases in its first year of operation (August 1995–August 1996) to 1,675 cases in 2005.

Despite its growing importance, mediation continues to be used ineffectively by many litigants and their counsel. Commonly, ineffective counsel fail to focus on the roles and differing goals that they, their client, and the mediator have in mediation. As a result, they approach mediation the same way they approach either bilateral negotiation or court-based dispute resolution.

The authors of this article focus their practices on customer/broker and other financial service industry disputes but from two different viewpoints. John Monical is an advocate retained by the financial services industry. Kent Lawrence is a mediator, engaged either directly by attorneys or indirectly through, for example, the NASD. This article offers the views of the advocate and the mediator, regarding their roles and strategies in the mediation process.

The Objective in Mediation

The Advocate's Objective

An advocate's approach to mediation should depend upon the advocate's goal. Unfortunately, many advocates believe that the goal is to win the mediation by shooting for the highest or lowest settlement number, respectively, for the plaintiff or the defendant. Attempting to win the mediation rarely serves the client's true interests.

In some cases, the goal in mediation may be to explore relief not available to the advocate's client in court. In other cases, the risk of continued litigation is not justified by the amount in controversy. Thus, the primary goal of mediation may be to resolve the case, even if the client has to pay the entire amount or walk away with nothing.

Even when the client's only concern is the bottom line in the current case, attempting to shoot for the absolute bottom or top in negotiations may not serve the client's interests. A broker should attempt to determine his client's objective and risk tolerance when recommending an investment. An advocate should do the same when recommending settlement or litigation. At each stage of negotiation, the advocate should make a risk/reward evaluation, considering the potential benefit of pushing the opposing party for additional concessions and the risk of losing the settlement. Attempting to win the settlement often exposes the client to a higher ratio of risk than is justified by the expected return.

Discovery is rarely an appropriate goal of mediation. Advocates rarely obtain information about their opponents' case through mediation that they could not learn more efficiently through direct discovery. In addition, an advocate who uses mediation as a discovery tool can develop a reputation for entering mediation in bad faith, which may leave both opponents and qualified mediators hesitant to mediate future cases with them.

The Mediator's Objective

The mediator's job is to get a settlement, not to "do justice." Everything this mediator does is calculated to move the parties toward settlement, not toward the "right" result. Even when this mediator argues with a party's valuation of a case, it is usually because he believes that modifying the party's valuation is necessary to reach a settlement, not because he cares about the accuracy of the valuation.

Choosing the Mediator

The Advocate's View

Remarkably, the same attorneys who create case-specific strategies for litigation often approach choosing a mediator as if every case were exactly the same. Some attorneys mistakenly hire their favorite mediator regardless of the case. Still others insist upon an evaluative mediator regardless of the issues. Choosing the "right" mediator, however, requires a case-specific analysis. It requires an advocate to compare the mediator's strengths and style with the goal of mediation and the obstacles to settlement.

Evaluative and Facilitative Mediation. These styles can be effective, but both have their limitations, depending upon the case and the client's goals. Evaluative mediators often focus on the likely outcome of a trial. As a result, when the client's goal is to explore alternative relief not available in litigation, a facilitative mediator may be the better choice. Facilitative mediators, however, are often less effective when the obstacle to settlement is the unrealistic expectations of the opponent or the advocate's own client. In these circumstances, an evaluative mediator may be the better choice.

Evaluative mediators are not always the best choice in extreme cases: frivolous cases, cases warranting punitive damages, or cases involving novel theories. Such cases are inherently difficult to value because the probability of success on an important aspect of the case is small. As a result, a small change in the assessed probability of success can result in large changes in the valuation.

Familiarity with the Substantive Area of the Law. This can be important if the obstacle to mediation is a difference in legal interpretation. Most cases, however, involve the application of relatively established law to strongly disputed facts where strong substantive credentials are less important.

The Statistical Success Rate of the Mediator. This is always important, but it is most vital in cases where reaching a settlement at any cost is a primary goal. Mediators with

strong success rates know how to bring and keep the parties at the table and know how to close the deal. A mediator with a strong success rate may not be pleasant to work with or may be most likely to keep the discussions going by pushing for movement from the advocate's own side of the case.

Mediators Recommended by the Opposing Party. This should be considered. An advocate should not assume that the opposing party's goal is inconsistent with his or her own client's goal. Both parties may want to settle. Both parties may be happy to trade off alternative relief not available at trial for concessions in the settlement payment. The opposing party may also recognize an obstacle to settlement that is not obvious to the advocate. If the opposing party's recommended mediator appears appropriate after the advocate personally performs an analysis of the mediator's qualifications and style, the advocate should accept the proposed mediator.

The Mediator's View

While the parties generally choose the mediator, the mediator should also consider whether he is right for the case. This author describes his style as that of a "pit bull, a hard reality-testing *'facilitator.'* " I generally do not use a soft touch with clients. While I do use my substantive experience in securities law, customer/broker disputes, and other areas, I do not evaluate cases for the parties. I would decline a case if I believed my style was going to be ineffective, but I would not withdraw in the middle of mediation if I learned my style was ineffective. I do, however, reserve the right to withdraw, or close the mediation prematurely, if I come to believe that a party or counsel is acting in bad faith.

Timing of the Mediation

The Advocate's and the Mediator's Shared View

One simple rule applies: "The earlier, the better." Because one of the primary reasons that cases settle is to avoid further litigation costs, last-minute mediations are not optimal. Thus, when mediation is appropriate for a case, mediation should be initiated as soon as possible.

The actual mediation session cannot be productive if one (or both) of the parties does not have the information it needs to evaluate the case for settlement, but an advocate rarely needs full discovery to evaluate a case. Sophisticated counsel will schedule mediation, exchange the necessary information voluntarily, and use the mediator to help resolve disputes over what will be exchanged. While advocates should not volunteer unfavorable information or disclose privileged or other protected information, advocates should willingly provide discoverable information requested informally by an opposing counsel or the mediator. Withholding such information rarely results in a more favorable settlement. More often, it eliminates any possibility of settlement and focuses the opposing party's discovery requests on the withheld information.

Preparing the Negotiation Field

Preparation is the key to a successful mediation. The advocate should prepare himself, his client, and his strategy before interacting with the mediator so that he can attempt to advance his mediation goals through the interaction. The mediator, by comparison, prepares himself and the advocates through interaction with the advocates and, usually, prepares his mediation strategy after that interaction.

The Advocate's View

Some advocates will spend a week of billable time preparing for each day of a trial but will enter mediation with no preparation other than a case evaluation. Lack of preparation reduces the likelihood of settlement, can embarrass the advocate in front of the client, and can hurt the advocate's reputation by creating the impression that the advocate entered the mediation in bad faith.

Preparing You and Your Client. The first step in mediation preparation is an interactive process between the client and the advocate. The advocate, who has investigated the essential facts and law applicable to the case, brings to this process a valuation and a list of possible business ramifications. The client, meanwhile, may bring his own valuation, his own list of business concerns, and most importantly, his own goals and priorities. The result of the interactive process should be to define the expectations of mediation and the roles the advocate and client will play during the mediation.

The first step in mediation preparation is an interactive process between the client and the advocate.

Unsophisticated clients may defer entirely to the advocate during the mediation. In these cases, the advocate has a greater role, but the process is still interactive. The advocate's responsibility includes explaining to the client how the mediation process works, what the client should expect, and the possible outcomes of mediation. The advocate must also form an opinion that his recommendations to settle or to litigate are appropriate for the unsophisticated client's objectives and litigation risk tolerance.

Sophisticated clients often know what to expect in mediation. In many cases, these clients choose to be a part of or to completely control the timing or presentation of information to the mediator. In these cases, the advocate may play a supportive role and should be careful not to overstep the limitations set by the client. More often, sophisticated clients want the advocate to present to the mediator but also want to approve each move the advocate makes during the negotiation. In some of these cases, the client withholds from the advocate the bottom line settlement number. This limits the advocate's role because it prevents the advocate from signaling the bottom line or possible future moves to the mediator. The client retains more control because the advocate must consult with the client not only about the amount of each move but also what the client wants the advocate to convey or signal in the presentation of the move during the negotiation.

Preparing Your Strategy. After ascertaining the goals,

expectations, and roles each of them will play during the mediation, the advocate and the client should prepare their strategy for reaching the client's goals. Often, preparing a strategy means knowing the numbers. If no settlement discussions have taken place, the advocate and client may wish to discuss an opening number. In addition, the advocate and client may wish to consider several backup numbers. Because new information or arguments will be presented in mediation that will change the valuation of the case, the advocate and client should be prepared to reconsider their bottom line number based upon new information as it becomes available.

Preparing the strategy for how to present arguments and numbers at mediation is an art form. Strategies may be based upon overcoming obstacles to settlement or, at times, exploiting them. They may involve calculated decisions about how and when information and concessions will be presented. They may also require the conscious or unknowing cooperation of the mediator. So many mediation strategies exist that it would be impossible to comprehensively present them in this article. However, credibility is one commonality required in almost any mediation strategy.

Credibility requires honesty. The advocate's job is to emphasize the facts and law favorable to the client, not to take liberties with the truth.

Credibility requires honesty. The advocate's job is to emphasize the facts and law favorable to the client, not to take liberties with the truth. If a mediator or opponent comes to believe the advocate or client is lying about the facts, misrepresenting the legal authority, or trying to hide something, achieving the client's goal may become impossible. Mediators who do not believe information presented by an advocate find it difficult to convincingly use that information when working the opponent. Opponents who believe they are being misled may become uncomfortable with the negotiation and either dig in their heels or cancel the mediation.

Perhaps the most common example of dishonesty damaging credibility in mediation is the mischaracterization of a settlement number as the client's "last, best, or final" offer or demand when, in fact, the client is willing to offer more or accept less. Although this characterization has been so misused that most mediators and advocates ignore it, this author has and continues to refuse to characterize a settlement offer as "last, best, final" unless the client first commits to continued litigation over one additional dime. While clients do sometimes recant their position, this author has established credibility that "final" means final.

Preparing the Mediator. Sophisticated advocates establish credibility and begin implementation of their mediation strategy through direct communications with the mediator well before the mediation. Implementing the mediation strategy, however, does not necessarily mean arguing your case.

In many cases, implementing the advocate's strategy means openly disclosing the strategy to the mediator. Mediators seek to settle, not to "do justice." Accordingly, if the mediator knows the strategy and believes it is likely to result in a settlement, the mediator may be interested in assisting, not hindering, its implementation.

Even if the advocate does not plan to share his or her mediation strategy with the mediator, the advocate should still prepare the mediator. To advance the client's goals, the advocate may want to identify the decision makers and point out obstacles to settlement. The advocate may also want to share goals that may not be obvious to the mediator or to provide input or documentation relating to specific issues of fact or law that will be discussed at the mediation.

During these discussions, the advocate should promptly and honestly provide any discoverable information the mediator may request. If the advocate produces the information, the advocate can control the format, the supplemental information provided to place the requested information in context, and can choose which supporting documents are reviewed. By comparison, if the advocate fails to provide the information, the mediator is likely to request the information from the opponent.

Often, an advocate may make more progress with the mediator through direct oral communications than through a mediation statement. Where a statement is requested, it should generally be short, should plainly state the issues, and should not overreach to sell a client's position. The statement should be consistent with the advocate's strategy in the issues it addresses and in how much information it provides. Unless it is inconsistent with the strategy, the statement should acknowledge the bad facts and law the advocate knows will be discussed but should not anticipate other arguments that have not yet been raised by the opponent.

The Mediator's View

The mediator has several distinct advantages over an advocate attempting direct bilateral negotiations. While the advocate is focused on the individual arguments, a mediator is focused on the entire negotiation field. To focus on the entire field, the mediator has to prepare.

Preparing Yourself. For the mediator, learning the substantive legal and factual issues is important. Where both advocates trust and openly communicate with the mediator, a properly prepared mediator may know more about the applicable arguments than either counsel independently. However, especially in the early stages, it may be just as important for a mediator to learn about the players.

The players in mediation are the decision makers—the individuals who can push a settlement forward or torpedo it. Often, the client is not the decision maker. The client relies entirely on its counsel, spouse, insurance adjuster, or the busi-

ness manager of the branch with the budget affected by the settlement. A mediator tries to prepare himself by learning as much as possible about these players, their evaluation of the case, and their objectives in the mediation.

Every interaction between the mediator and anyone else in the case is an opportunity to learn about the players. This mediator starts evaluating the players immediately, even as a prospective mediator doing a conflict check. For example, how quickly counsel provides information tells this mediator something about how seriously and professionally the attorney will approach the mediation, the information provided about who will appear at mediation can identify the decision maker, and the two sentences an advocate chooses to describe the case can indicate the issues he sees as primary.

Preparing the Advocates. While the mediator is trying to prepare himself, he is also trying to prepare the advocates. Part of preparing the advocates includes urging each side to prepare themselves. Lack of preparation by counsel can lengthen the mediation session and can weaken or destroy any momentum toward settlement.

From the beginning, the mediator also tries to prepare the advocates by connecting with counsel. In every interaction, the mediator tries to build credibility with counsel—to convince the advocates and the clients that the best way to reach their goals is to openly communicate and cooperate with the mediator. The mediator also encourages counsel to prepare and think realistically about the possible outcome of mediation and to discuss expectations for the case with his client.

Preparing the Strategy. The mediator must consider the particular dispute and people involved in order to implement a strategy. In good circumstances, the mediator has at least an idea of the range within which settlement might occur and may have a better idea than either counsel has of where the opposing side is willing to go. The mediator also, hopefully, has identified the obstacles to settlement. He then plans his strategies for dealing with these obstacles and may use materials given to him by counsel.

The Opening Joint Session

The Mediator's View

In some cases, the mediator can use the session to get some useful work done. Getting confirmation concerning apparent areas of subsidiary points of agreement can be useful. For example, in some cases, the parties are in agreement as to net out-of-pocket loss, without realizing it. Even where there is no substantive agreement, it is often possible to make progress by agreeing on the definition of the dispute—to articulate and clarify the disagreement—without blowing up the process.

However, the joint session, if not handled correctly, can increase the animosity between the parties and/or the advocates, increase the time the mediator needs to settle things down, and increase the difficulty for a mediator trying to bring the parties together. As a result, the mediator's goal often is to discourage any joint session or to minimize the damage caused by it. For example, a joint session may be necessary because one or more parties or decision makers need to "vent" before they will be emotionally able to reasonably discuss the issues. The mediator may attempt to minimize the animosity created by the venting by preparing the opposing advocate or party in advance.

The Advocate's View

In cases with experienced clients and counsel, an opening statement is usually not necessary or helpful. Yet, some advocates feel compelled to give an opening statement to impress the client. In planning an opening statement for mediation, the advocate should ask one simple question: "How does this opening statement advance the mediation strategy or the goals of the client?"

An opening statement may advance the strategy of giving an emotional client a chance to speak and a feeling of having had their day in court. It may advance a strategy of expressing sympathy for the hardship of a plaintiff. Finally, an opening statement may give advocates an opportunity to acknowledge and possibly to diffuse the weak points of their case. If the only purpose for the opening statement, however, is to restate the position already communicated, the opening statement probably is not necessary.

Working in the Caucuses

The Mediator's View

From my experience, the mediator cannot easily predict from his preparation whether the mediation will be difficult or easy or whether it will result in settlement. Cases that at the front end appear impossible to settle have proven relatively easy. Similarly, cases that initially appeared easy to settle, have proven not only difficult, but occasionally have failed. The private caucus is where the hidden obstacles to settlement become apparent and where the real work by the mediator largely gets done.

Each caucus is very case- and counsel-party specific. Negotiations of substantively similar cases are totally different because the players are different. This mediator has mediated customer claims against the same broker over the same investments and period of time where the same attorneys represented the parties. These nearly identical cases can be unique and sui generis because one player—the customer—changes the entire interaction between all the players.

There are many different mediator strategies. Thus, how and when to apply those strategies is an art form. Once in caucuses, the mediator must simultaneously track the progress, moves, and often shifting goals of the players on both sides—always with the objective in mind to get a deal. To facilitate this, the mediator wants to accomplish two things: to keep the numbers moving and to keep the parties at the table.

To get the parties to move, the mediator is consistently focused upon the MLATNA proposition—urging each side to compare the settlement value with the value of the "Most Likely Alternative to a Negotiated Agreement." In some cases, this requires pushing the parties to adjust their valuation of the MLATNA alternative.

Unfortunately, the private caucuses are often more difficult because the parties start by taking a step backward. In some

of these cases, the advocate or the client takes a step back by simply changing its position since last speaking to the mediator. Then, the mediator must first get the parties back to their starting positions.

In other cases, the advocate simply failed to prepare the case or the client before the mediation. Then, the mediator spends time early in the private caucus attempting to do that preparation. In these circumstances, the mediator hears, for the first time, the client's goals or valuation of the case. Sometimes, these goals and valuations are different from the goals and valuations the attorney previously brought to the mediator.

In other cases, the mediator's function in private caucus is to help counsel with a difficult client. Whether counsel originally misevaluated the case because the client "forgot" to advise him of some adverse facts, or upon further investigation and discovery such adverse facts are uncovered, the client often remembers the original evaluation and has a hard time accepting unfavorable revision of that evaluation. If counsel cannot adjust the expectations of the client, he or she may need the mediator's help to accomplish the task in private caucus. If counsel is not astute enough to communicate this to the mediator without prompting, the mediator should elicit such information from counsel in the early ex parte phone calls.

From the mediator's viewpoint, movement in settlement numbers is only good if it advances the goal of reaching a settlement. As a result, a mediator must weigh movement by a party against the important goal of keeping the parties at the table. Sometimes, to prevent a party from walking away from the table, the mediator must limit the party's movement and stockpile ammunition to use against one or both sides when movement becomes more difficult. This is a place where the advocate can further his objective by helping the mediator to sell his case to the other side. He can both feed new data or points to the mediator and interactively work with the mediator to formulate the timing and delivery to the other side.

To keep the session from breaking down, the mediator must always be looking for "the wall"—the number at which either party walks away from the mediation. The mediator tries to spot the wall in advance of hitting it to avoid hitting it. If the mediator has room to maneuver before hitting the wall, the mediator may be able to avoid hitting it, either by working to move the wall or by working to settle at the wall.

The advocate and client do not gain any advantage by failing to credibly inform the mediator when the mediator is approaching the wall. To the contrary, failing to inform the mediator usually prevents the advocate from finding out the best deal the other side might have offered. However, if the mediator hits the wall with no prior warning from counsel, there is little the mediator can do. Mediators have techniques for getting off the wall, but they tend toward desperation or high risk. Smart mediators try to head that off—and smart counsel help the mediators by credibly indicating to the mediators when the wall is approaching.

This mediator warns, however, that after a mediator realizes the advocate or client has identified a false wall, the mediator is unlikely to find credible any further warning that the mediator is approaching the real wall—leaving no effective tools for avoiding it.

The Advocate's View

How an advocate and client make their moves in caucuses depends in part on the mediation goal. If the goal is to settle at any price, moves in settlement position should be more reactive, with an eye toward keeping the opponent at the table. By contrast, if the goal is to settle at the right price, the moves should be calculated to convey a target settlement price. If the goal is to obtain alternative relief not available in court, the settlement moves may be calculated to achieve the ideal timing for the request for alternative relief. One approach is to wait until numbers are nearly reached to address the prospect of alternative relief. The advantage of this approach is that the opponent may be enticed by the nearness of the settlement. Another approach is to couple the alternative relief with a specific move in settlement amount, which can provide a feel that the client purchased the alternative relief by the move in the settlement amount.

Finish It Off or Risk Being Finished Off by It

The Advocate's and Mediator's Shared View

At the end of the mediation session, after agreement seems to have been reached, both the mediator and the advocates should push for a written summary of settlement terms with signatures by the parties. Failing to obtain such an agreement creates the risk that one party will pull out of the settlement. This inevitably spawns new litigation, which is unfavorable to all involved.

While both the mediator and the advocate want an agreement, the mediator is more interested in the enforceability of the agreement than the specific settlement terms. The advocate, by contrast, is very concerned with the settlement terms and should make sure that the agreement addresses all issues of importance to his client. The advocate should anticipate this process and bring to the mediation any confidentiality, release, or other language that the advocate will insist upon as part of the settlement agreement. Advocates who do not have such language with them at the mediation may be forced to agree that the parties will work out a more formal settlement agreement after the mediation, which relieves the pressure of an on-the-spot agreement but leaves the settlement terms open to further debate and increases the risk of buyer's remorse.

Conclusion

Mediation is a very proactive and interactive endeavor that cannot be approached effectively with a standardized formula. However, an advocate who focuses on the different, but overlapping, objectives of the client and the mediator can effectively use the mediator to advance the client's goals. ✱

Mr. Monical is a managing member and Mr. Lawrence is a member of the Chicago law firm of Lawrence Kamin Saunders & Uhlenhop, LLC. Rhonda V. Turner, an associate with their firm, aided in the preparation of this article.