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Has the Reasonable Inquiry Standard Changed After *Qualcomm*?

BY SETH J. REIDENBERG

Special to the Legal, PLW

“**H**as my client provided me all of the responsive documents to the opponent’s document requests?” This is a question that every litigator must ask, whether representing individuals or corporations of any size. How we satisfy ourselves that the answer to that question is yes can and does vary. However, since the decision in *Qualcomm Inc. v. Broadcom Co.*, both lead and local counsel may need to rethink how they go about answering that question. Otherwise, it could cost you money, your reputation and possibly your career.

DISCOVERY VIOLATIONS

Qualcomm initiated a patent infringement action against Broadcom for infringement of two different patents in the U.S. District Court for the Southern District of California. In its answer to the complaint, Broadcom asserted, as an affirmative defense, that both patents were unenforceable due to waiver. Broadcom predicated its waiver defense on the assertion that Qualcomm participated in the Joint Video Team (JVT), a standards-setting body related to the patents at issue. If Qualcomm had participated in the JVT in 2002 or early 2003, it would have been prohibited from suing companies under the two patents at issue.

Through discovery, Broadcom sought information from Qualcomm concerning Qualcomm’s participation in the communications with the JVT. Broadcom used the wide array of discovery techniques available to it under the Federal Rules of Civil Procedure, including requests for production, interrogatories, and 30(b)(6) depositions.

Throughout the course of the litigation, Qualcomm represented that it did not participate in the JVT. For example, Qualcomm presented two witnesses in response to 30(b)(6) deposition notices seeking individuals who were “most knowledgeable on the issue of Qualcomm’s involvement in the JVT.” At the 30(b)(6) depositions, the witnesses testified that Qualcomm had never been involved in the JVT. Later, it was discovered that prior to the witnesses’ depositions, neither Qualcomm nor its attorneys searched their computers for any relevant documents or e-mails. The attorneys who prepared the witnesses for their depositions also did not provide them with any information to review.

Qualcomm also responded to Broadcom’s document requests by asserting approximately 17 familiar (and some not so familiar) general objections but indicated that Qualcomm would produce “non-privileged relevant and responsive documents describing Qualcomm’s participation in the JVT, if any, which can be located after a reasonable search.” However, no documents were ever produced.

After the conclusion of discovery, Qualcomm moved for summary adjudication, arguing to the district court that the



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evidence (or lack thereof) established Qualcomm’s non-participation in the JVT. In support of its motion for summary adjudication, Qualcomm submitted an expert declaration prepared by Qualcomm’s attorneys that confirmed the absence of any corporate records indicating Qualcomm’s participation in the JVT. Qualcomm also filed a motion in limine seeking to exclude evidence relating to its participation in the JVT, arguing that the facts demonstrated that it did not participate in the JVT.

At trial, in his opening statement, Qualcomm’s attorney represented to the jury that it did not participate in the JVT in 2002 and early 2003.

Unfortunately, after the trial began, things started to unravel for Qualcomm. While preparing Qualcomm witness Viji Raveendran to testify at trial, counsel for Qualcomm discovered an e-mail dated Aug. 6, 2002, that indicated she had participated in the JVT. Several days later, a search performed on Raveendran’s laptop revealed 21 separate e-mails, none of which had been produced in discovery, but all of which indicated some level of participation in the JVT prior to early 2003. The Qualcomm trial team decided not to produce these newly discovered e-mails to Broadcom, claiming they were “not responsive to Broadcom’s discovery requests.” They also did no additional investigation to determine whether there were more e-mails that indicated that Qualcomm had, in fact, participated in the JVT prior to early 2003.

At trial, Raveendran testified on direct examination. Counsel for Qualcomm carefully crafted his questions to avoid revealing the fact that she had received the 21 e-mails related to the JVT. Instead, Qualcomm’s counsel was asked whether Raveendran had any knowledge of having read any e-mails related to the JVT. On cross-examination, Broadcom’s counsel asked Raveendran the right question, whether she had received any e-mail related to the JVT. At this point, Raveendran was forced to admit that she had received these e-mails. Qualcomm was then forced to produce the 21 e-mails. Qualcomm did no additional searches. At the conclusion of the trial, the jury returned a unanimous advisory verdict in favor of Broadcom based on inequitable conduct and waiver related to the two patents.

THE MOTION FOR SANCTIONS

Broadcom’s attorneys orally moved for sanctions against Qualcomm based on Qualcomm’s failure to produce the 21 e-mails discovered on Raveendran’s computer. While the motion for sanctions was

pending, Qualcomm conducted additional document searches. Qualcomm notified the district court that based on the new searches, it had discovered tens of thousands of responsive documents that had been requested in discovery but were not produced.

The motion for sanctions was referred to Magistrate Judge Barbara Major, who, after hearing argument on Broadcom’s motion for sanctions, issued a rule to show cause to all of the attorneys representing Qualcomm — including any and all attorneys who signed discovery responses, signed pleadings and pre-trial motions, and/or appeared at trial on behalf of Qualcomm — to show cause why sanctions should not be imposed for their failure to comply with the court’s discovery orders.

Major considered the decision of the district court, the written and oral arguments of the litigants, and the declarations of 19 of Qualcomm’s attorneys, and she concluded that Qualcomm intentionally withheld tens of thousands of decisive documents from its opponent in an effort to win the case and gain a strategic business advantage over Broadcom. Major further concluded that Qualcomm’s attorneys must have assisted Qualcomm in achieving this goal. As a result of this conclusion, Major referred six attorneys to the State Bar of California and sanctioned Qualcomm in the amount of \$8,568,632.24, in addition to awarding Broadcom all of its attorneys fees and costs incurred in the litigation.

COMPLIANCE WITH RULE 26

With all of the potential pitfalls faced by an attorney in responding to discovery requests — especially with electronic discovery — what steps can you take to help you sleep at night and avoid the nightmare experienced by Qualcomm’s attorneys? Federal Rule of Civil Procedure 26(g)(1) requires individual attorneys to sign every discovery request, response or objection made and such signature constitutes a certification that to the best of the attorney’s knowledge, information and belief, formed after a reasonable inquiry, the request, response or objection is consistent with the rules and the law, not interposed for an improper purpose, and not unreasonable or unduly burdensome or expensive. The advisory committee notes to the Federal Rules of Civil Procedure state that Rule 26(g) imposes an affirmative duty to engage in pretrial discovery in a responsible manner that is consistent with the spirit and purposes of Rules 26-27. An attorney who makes an incorrect certification without substantial justification must be sanctioned by the court.

How then, in a world dominated by electronic data stored on laptops, PDAs, personal computers, employer servers, Internet servers, etc., do you comply with the “reasonable inquiry” obligations imposed by Rule 26(g)(1)? Although there is not one clear answer, there are definite lessons to be learned from reviewing Major’s decision.

First, make certain that there is sufficient communication between your client

and you, you and co-counsel, and you and the attorneys within your firm assigned to the case. One of the most significant deficits identified by Major was the lack of communication between the junior attorneys assigned to the case and the more senior counsel.

Second, create a discovery plan and include your client (and local counsel if applicable) in the creation of the plan. Next, identify and assign more senior attorneys to communicate with the client, especially regarding discovery issues. More senior attorneys have a greater ability to identify the importance of certain documents to a case and to communicate to the client the importance of producing all of the responsive documents (including the bad ones) to opposing counsel.

Lastly, in this world of electronic discovery, you need to be proactive. You need to meet with your client and its IT manager so you can understand what types of data might exist, where that information can be found, and how best to retrieve it. You should consider retaining a third-party consultant to assist you in responding and producing electronic discovery.

In the past, under the reasonable inquiry standard of Rule 26(g), an attorney was permitted to rely on the assertions of the client as long as that reliance was appropriate under the circumstances. There appears to be a trend developing in the federal courts that places a greater burden on counsel to do more.

As the court in the recent case of *Bd. of Regents of the Univ. of Nebraska v. BASF Corp.* noted:

“The overriding theme of recent amendments to the discovery rules has been open and forthright sharing of information by all parties to a case with the aim of expediting case progress, minimizing burden and expense, and removing contentiousness as much as practicable. See e.g., 1993, 2000, 2006 Amendments to Federal Rules of Civil Procedure, Advisory Committee comments to Rules 26, 33, 34, 37, 28 U.S.C. Compliance with these changes has placed on counsel the affirmative duties to work with clients to make required disclosures, Rule 26(a)(1)(2) and (3); reduce oppression and burden, Rule 26(b)(2); cooperatively plan discovery with opposing counsel, Rule 26(f); affirmatively certify accuracy and good faith in requesting and responding to discovery, Rule 26(g), and confer with opposing counsel to resolve disputes before filing certain motions, Rule 37(a)(2)(B), among others. If counsel fail in this responsibility — willfully or not — these principles of an open discovery process are undermined, coextensively inhibiting the courts’ ability to objectively resolve their clients’ disputes and the credibility of its resolution.”

With this changing tide, every attorney needs to take control of document production. If you take control and are proactive, you can hopefully avoid the harsh results imposed on Qualcomm’s counsel. •

Insurance Coverage for Food Contamination

BY MICHAEL R. KELLEY

Special to the Legal, PLW

Since 2001, there have been more than 1,645 food recalls or warnings in the United States. These include chicken and turkey in 2002, due to suspected *Listeria* contamination; the 2006 contamination of spinach with *E.coli* that cost the industry 20 percent of its business; and the 2008 recall of 143 million pounds of beef due to allegedly improper inspection techniques.

The focus of these food contamination scares, as it should be, has been on the health and safety of consumers. But how does the food industry protect itself from economic losses, such as the estimated \$350 million of reduced revenue suffered by the spinach industry due to the *E.coli* outbreak? Increasingly, the industry is looking to insurance coverage. The coverage that most food industry insureds have, however, is often inadequate and sometimes useless.

THE OUTBREAK OF 2006

In September 2006, reports of suspected *E.coli* contamination began to trickle in to the Food and Drug Administration (FDA). Within a few days, the FDA received information that three people had died and many others had become sick from *E.coli* in 26 different states. The FDA issued a warning to consumers to stop eating fresh spinach. News media gave high priority to reporting on the outbreak and the FDA's warning. As a result, the sale of spinach came to a virtual halt.

For three weeks, the saga played out until the FDA finally announced that it had isolated the source of the *E.coli* contamination to one spinach producer in California. It then lifted its warning, except as to the lone California producer. Nonetheless, the damage to the spinach industry was done. The industry continued to suffer income losses for months afterward.

A similar scenario often plays out whether the issue is *E.coli* in spinach, "mad cow" in beef or any other food-borne contaminate. There are food producers whose products are directly implicated as being contaminated, and there is the reduction in the entire demand for the product both during the initial uncertainty of the origin of the contaminate, and usually for some time thereafter until consumers regain trust for the product.

In most food contamination scenarios, the food production business has two sources of economic loss: the loss of the product itself, which, in many instances, has to be destroyed or spoils due to the inability to sell it; and loss of business income. In most cases, the standard commercial property coverage and business income coverage forms are insufficient. There are several reasons for this, one of which is that most standard policies exclude coverage for contamination.

INSURANCE OFFERED

The insurance industry has recognized that there is a market among food industry



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insureds for particular coverage for food contamination. The standard "Food Industry Amendatory Endorsement" offered by one leading insurance company is illustrative of the type of specific insurance coverage for food contamination that exists in the market.

In pertinent part, the property damage form provides: "We will pay for accidental loss to 'stock' caused by contamination by a foreign substance (other than by a refrigerant), or dampness or dryness of atmosphere while such 'stock' is located on your premises described in the declarations."

Based upon this language, an insured is covered only if its product was actually contaminated by a foreign substance and the contaminated product is located on the insured's premises. This language would seem to exclude coverage for suspected contamination, or for contaminated product located away from the insured's premises. Therefore, food producers who must destroy their own uncontaminated products due to a contamination scare will likely not be protected even by the food contamination endorsement.

Given the nature of the food contamination cases, the most severe economic loss may be in the form of business income loss. For instance, the amount of stock that a food industry insured would have to destroy as a result of an outbreak may be minimal in comparison to the continued income loss that results from an extended market reluctance to buy a particular food item.

The standard food industry endorsement provides, with respect to business income coverage:

"We will pay you for the following actual costs incurred, as indicated below, if a 'Public Health Authority' requires that your 'operations' be suspended due to discovery of, suspicion of, or exposure to "food contamination" at your locations. Where a Business Income Limit of insurance is shown in the Declarations:

- "We will pay for:
- The actual loss of 'business income' you sustain until the 'suspension' is lifted by the 'Public Health Authority';
 - Your cost to clean and sanitize your machinery and equipment as directed by the 'Public Health Authority';
 - Your cost to replace your food declared contaminated by the 'Public Health Authority' and
 - The extra cost of advertising including, but not limited to the expense of telephone, radio, television, newspaper and other media announcements."

In terms of definitions, "food contamination" means a condition in food, which is caused or is suspected of causing food poisoning of one or more of your patrons. Such 'food contamination' must result from tainted food, purchased by you, or from a "communicable disease" transmitted by one or more of your employees. 'Communicable disease' means a bacterial microorganism transmitted to customers through human contact with food."

The standard policy further defines "suspension" as "the period of time that begins with the notification from the 'Public Health Authority' that your operations are to be temporarily closed and ends with the notification from the same 'Public Health Authority' that your operations can be resumed."

There are a number of limitations under the above language. First, under the endorsement, a public health authority has to "require" that your operations be suspended due to discovery of, suspicion of or exposure to food contamination. This may be problematic for spinach growers and processors in the 2006 *E.coli* case. There, the FDA merely issued a warning to consumers that they should not purchase or consume spinach products. The FDA did not issue an order or similar edict to businesses in the spinach industry that prevented such businesses from selling the products. In response to the FDA warning, the market simply reacted by effectively shutting down the spinach industry.

Further, the endorsement requires a

public health authority to actually notify a business that its operations are to be temporarily suspended. Again, in the *E.coli* situation in 2006, the FDA did not notify any spinach grower, processor or retailer to close its operations (with the exception of the lone grower in California that was the source of the contamination). Accordingly, it may be difficult for any insured under the food industry endorsement to obtain recovery for business income losses under the kinds of circumstances that existed in the *E.coli* scare of 2006.

Spinach industry insureds are expected to argue that the FDA's warning effectively required growers, producers and others in the chain of distribution to suspend operations for at least the three-week period that the FDA warning remained in effect. It remains to be seen how courts in the numerous affected states will interpret the policy language of the food industry endorsement.

COURT RULINGS

The courts that have considered food contamination cases have reached conflicting results as to insurance coverage. The 8th U.S. Circuit Court of Appeals held, in November 2006's *Source Food Technology Inc. v. United States Fidelity & Guaranty Company*, that a food producer had no business income coverage when the USDA prohibited beef importation from the food producer's only beef supplier due to suspected "mad cow" disease. The court found that since none of the beef supplied by the Canadian beef supplier was actually contaminated, the food processor could

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SEC Enforcement: Investigations, Actions and 2008 Trends

BY ALEXANDER D. BONO

Special to the Legal, PLW

Six hundred and fifty-seven cases. That's the number of securities law violation cases brought in fiscal 2007 by the U.S. Securities and Exchange Commission. It was up 14 percent from 574 cases in 2006.

This increase has two contexts. The first is conceptual — the SEC is a law enforcement agency with a tripartite mission: protect investors; maintain fair, orderly and efficient securities markets; and facilitate capital formation. The second is practical — the SEC has sophisticated tools and techniques, and robust programs.

What's the result? Increased law enforcement means increased risks and headaches for those under the SEC's jurisdiction. To understand better, let's look summarily at how the SEC enforces securities laws through investigations and actions. Then, let's focus on four trends in SEC's 2008 enforcement agenda: subprime initiatives, senior fraud, insider trading and stock option backdating.

INVESTIGATIONS

The SEC invests huge amounts of resources investigating possible violations of the federal securities laws. All SEC investigations are confidential and nonpublic. But leaks are inevitable. And, despite the SEC's emphasis that investigations don't necessarily mean violations have occurred, history proves that even the suggestion of securities violations is insidiously negative.

Also, the SEC plays by its own set of rules. They differ substantially from the federal rules, offering limited protection. However, "confidential treatment" under the Freedom of Information Act can and should be requested to prevent access by third parties to anything supplied during an investigation.

Finally, investigations are the SEC's enforcement cornerstones. Except for emergencies, the SEC rarely initiates enforcement actions without the staff of its Division of Enforcement recommendation after investigation. Plus, since the vast majority of SEC matters settle, an investigation may be the only chance to explain the truth.

The staff of the SEC's Division of Enforcement — which is composed primarily of skilled lawyers who can enlist highly technical expertise from the SEC's divisions and offices — start investigations. Numerous sources trigger SEC investigations, including: "market surveillance;" public filing reviews; tips (these are often anonymous, from whistleblowers, investors or disgruntled employees, and are encouraged on the SEC's Web site and supported by "bounties"); news media reports; or referrals from other SEC divisions and offices, or securities industry sources.

There are four basic types of SEC investigations. As a best practice, on receiving notice of any type, counsel



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experienced with the SEC's investigative process should be engaged immediately. Responding without experienced guidance is a formula for disaster. The four types of investigation are as follows:

- **Inspections:** The SEC's Office of Compliance Inspection and Examinations (OCIE) inspects broker-dealers, investment advisers and other regulated entities. Increasingly, OCIE examinations result in referrals of possible securities violations.

- **Preliminary inquiries:** These start when the staff receives red flags of possible violations. They involve a narrow analysis of data that is informally collected.

After review, staff may decide that more comprehensive investigations are needed.

- **Informal investigations:** These collect more documents and data, with more and deeper analysis. The staff usually takes telephone interviews or sworn testimony, but it lacks subpoena power, so it encourages voluntary cooperation. For those who refuse to cooperate, staff customarily seeks a formal order of investigation.

- **Formal investigations:** Based on staff recommendations, these start when the commission issues an authorizing order. Formal orders usually list potential violations, designate investigative officers, and are "nonpublic." Copies can be requested from the staff. Designated staff has subpoena power to compel production of data and documents, sworn witness testimony and other information. Counsel can represent witnesses, but the staff has wide latitude. Witnesses should hire counsel who is both knowledgeable of the SEC's testimony process and skilled at preparing for it.

Publicly traded companies under SEC investigation face a complex disclosure dilemma that transcends the scope of this article. Suffice it to say that SEC regulations provide for disclosure of material "legal proceedings" and of

"proceedings known to be contemplated" by the government, and legal precedent may require disclosure under antifraud provisions that preclude material omissions.

As a best practice, prudence dictates interdisciplinary advice from corporate disclosure lawyers and experienced SEC defense lawyers. Careful review is warranted at various times, including after notice of investigation, when investigations shift from informal to formal, and after a Wells notice, a letter the SEC sends when it plans to bring an enforcement action.

Staff generally advises about the opportunity to make a Wells submission — a brief to the commission and staff arguing against the proposed action — when giving notice that it intends to recommend enforcement action. As a best practice, many experienced defense lawyers advise against filing a Wells submission, because staff rarely is persuaded to drop or reduce its recommendation, and senior staff or the commission rarely rejects the staff's recommendation. So the staff's invitation for a rare result must be balanced against the risks,

including premature disclosure of defenses, or discovery in subsequent investor class actions.

ENDING INVESTIGATION

Parties under SEC investigation yearn for an end. Theoretically, the SEC has discretion to give notice that the investigation will close without a settlement or an enforcement action. But, the staff does not give closure notice as a matter of course. Rather, many investigations simply languish. The

SEC had 3,700 open investigations according to a September 2007 Government Accountability Office report. More than 2,400 had been open for at least two years. More than 450 were more than 10 years old.

SEC enforcement actions create enormous anxieties and uncertainties. They are extremely expensive and difficult to defend successfully; as a result, they usually settle. Prior settlements from similar cases serve as benchmarks, with staff negotiating somewhat inflexibly against such terms. So review of the public record is advisable. Typical negotiated terms include the following: disgorgement; monetary penalties; bars against officer or director service; affirmative undertakings of corrective or prophylactic action; and an SEC cease and desist (C&D) order or federal court order. In a

C&D, the consenting party generally neither admits nor denies the staff's charges or findings.

SEC ENFORCEMENT ACTIONS

SEC enforcement actions can include civil actions, administrative proceedings and criminal prosecutions. Under the Securities Exchange Act of 1934, the chief violations are for fraud; books and records and internal controls; proxy solicitation; misleading statements in SEC filed reports control person and aiding and abetting liability; and insider trading. Similar charges can exist under the Securities Act of 1933 for fraud, control person liability, false registration statements and false statements in prospectuses.

As to remedies, both the 1934 Act and the 1933 Act authorize investigations and prosecutions; injunctions restraining future violations; bar orders prohibiting fraud violators from acting as an officer or director of a public company; and civil money penalties in three tiers. The SEC can also issue reports of investigation, which impose no formal sanction but may generate considerable adverse publicity. A famous example is the *Seaboard* Section 21(a) Report, which announced the SEC's criteria for crediting self-reporting and cooperation in an investigation.

Civil penalties for insider trading include treble damages of the profit made or loss avoided. Civil administrative remedies exist against broker-dealers, associated persons and their supervisors, including three tiers of civil penalties. And, cease and desist proceedings permit asset freezes in federal court.

Finally, 1934 Act criminal penalties include fines of \$5 million and imprisonment of 20 years for individuals, and \$25 million fines for other persons. Under the 1933 Act, criminal penalties include fines of up to \$10,000 and imprisonment of up to five years.

TRENDS, 2008 AGENDA.

"Exceptionally ambitious." That's how SEC Chairman Christopher Cox describes the SEC's 2008 agenda. To execute this plan, the SEC is now using informal working groups, or task forces, to develop stronger investigations and more consistent results. Four areas top the SEC's list for the coming year: subprime initiatives, senior fraud, insider trading and stock option backdating.

The SEC has created a Subprime Task Force, and at least 15 subprime investigations were underway at 2008's start. The task force is looking for fraud or breaches of fiduciary duty in the offering and sale of collateralized debt obligations. Specifically, bank holding companies and securities firms are being investigated on the adequacy of disclosures about their collateralized debt obligation portfolios and valuations. The SEC also is examining whether brokers satisfied investor suitability requirements when selling these securities.

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The SEC has created a Subprime Task Force, and at least 15 subprime investigations were underway at 2008's start. Specifically, bank holding companies and securities firms are being investigated on the adequacy of disclosures about their collateralized debt obligation portfolios and valuations.

Business as Usual for 3rd Circuit, *Twombly* Notwithstanding

Pleading Standard Under Rule 8 Remains Intact

BY M. NORMAN GOLDBERGER
AND SHANON S. LEVIN

Special to the Legal, PLW

Imagine that you are a federal district court judge. Now imagine that you have been asked on a motion to dismiss to evaluate the sufficiency of a complaint. In the wake of the U.S. Supreme Court's May 2007 decision in *Bell Atlantic Corp. v. Twombly*, how do you apply what appears to be a new standard for pleading federal complaints, which mandates that allegations meet a "plausibility, not possibility" standard? What set of criteria do you apply to determine whether the complaint before you contains "enough facts to state a claim to relief that is plausible on its face"? If you are sitting in a district court in the 3rd U.S. Circuit Court of Appeals, it's probably business as usual.

TWOMBLY

In *Twombly*, the Supreme Court, on a motion to dismiss an antitrust suit, held that allegations that regional providers of telephone and Internet services had engaged in "certain parallel conduct unfavorable to competition, absent some factual context suggesting agreement," should be dismissed. The Supreme Court rejected the argument that the plaintiffs had adequately pleaded conspiracy by averring that despite deregulation intended to increase competition, telephone and Internet markets remained highly compartmentalized geographically, with minimum competition.

Conceding that "sparse competition among large firms dominating separate geographical segments of the market could very well signify illegal agreement," the Supreme Court nevertheless found the pleading insufficient, as there was an "obvious" (and lawful) "alternative explanation." The court "retired" the "no set of facts" portion of its 50-year-old maxim from *Conley v. Gibson*, that "a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief."

The *Twombly* court reasoned, "[a]sking for plausible grounds to infer an agreement does not impose a probability requirement at the pleading state; it simply calls for

enough fact to raise a reasonable expectation that discovery will reveal evidence of illegal agreement." The court denied that it was applying a "heightened" pleading standard, but rather, "only enough facts to state a claim to relief that is plausible on its face. Because the plaintiffs here have not nudged their claims across the line from conceivable to plausible, their complaint must be dismissed." In contrast, the dissent characterized the holding as a "dramatic departure from settled procedural law."

Two weeks after appearing to cast *Conley*

aside, the Supreme Court returned to *Conley* (as quoted in *Twombly*) in vacating the dismissal of a pro se civil rights complaint by an individual prisoner in the case of *Erickson v. Pardus*. The lower courts had held that apart from "conclusory allegations," the plaintiff failed to allege that he suffered harm as the result of the prison's discontinuance of hepatitis C treatment, other than the harm he already faced from the condition itself. The Supreme Court granted review on the ground that the appellate court's "holding departs in so

stark a manner from the pleading standard mandated by the Federal Rules of Civil Procedure." The Supreme Court then vacated the dismissal, explaining that the plaintiff had satisfied Rule 8(a)(2) by alleging that the doctor's decision to remove him from the medication shortly after the yearlong treatment began and refusing to provide treatment was endangering his life.

Within just three weeks of the *Twombly* decision, the 2nd Circuit, the first federal appellate court to analyze the opinion, observed in *Iqbal v. Hasty* that *Twombly* had created "[c]onsiderable uncertainty concerning the standard for assessing the

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not establish the insurance policy's requirement of showing "direct physical loss" to the food product.

Likewise, in *Cooper v. The Travelers Indemnity Company of Illinois*, a California court found that a tavern owner had no right to recover for lost business income when the tavern was forced to close due to E.coli contamination. Interestingly, the court did not deny coverage outright, but determined that the tavern owner could not establish any diminution in its profits because of the E.coli contamination.

On the other hand, the Superior Court of New Jersey, in *Customized Dist. Serv. v.*

Zurich Ins. Co., held that a juice distributor suffered "direct physical loss" of bottled juice because the product became too old to sell at market prices due to being warehoused too long. Likewise, a Federal Court in Louisiana held in *Fireman's Fund Ins. Co. v. Community Coffee Co.* that coffee that admittedly did not suffer either water or mold damage from Hurricane Katrina nonetheless may have suffered "direct physical damage" from the mere existence of floodwaters near the warehouse. The court thus denied the insurer's motion for summary judgment.

CONCLUSION

The food industry in the United States, and in particular in Pennsylvania, is a significant part of the economy. The

food contamination cases just in this century have caused hundreds of millions of dollars in economic losses for businesses in the food industry. Many of the businesses that have looked to reduce their risk of loss due to a food contamination scare have purchased food contamination or food recall insurance coverage. The language of the form policies, as well as the few cases that have been decided on these issues, demonstrate that the insurance coverage may be available to cover the economic loss, but the courts have not settled on a consistent interpretation of the policies.

It is recommended that food industry insureds that seek greater protection for economic losses due to food contamination consider the following:

- Be aware of the limitations of the standard policies and negotiate coverage that better protects the insured's potential economic losses;
- Use indemnity agreements with suppliers that cover the insured in the event that the supplier's contaminated product results in direct and consequential economic losses; and
- Obtain adequate limits of business income coverage.

Many insureds have limits of \$50,000 or less of business income loss, assuming that they will overcome any diminution in business in short order. In the food contamination instances, the economic losses may continue for several months and exceed the coverage amounts. •

Twombly

continued from L5

adequacy of pleadings." In response to the opinions in *Twombly* and *Erickson*, parties in countless federal cases filed new motions to dismiss or filed supplemental briefs on pending motions to dismiss. Numerous federal courts ordered or permitted the amendment of complaints to meet the newly announced standard. By early March of this year, a search on Lexis or Westlaw showed that *Twombly* has been cited in nearly 9,000 decisions since the Supreme Court issued its opinion.

PHILLIPS

On Feb. 5, the 3rd Circuit provided its first thorough analysis of the impact of *Twombly* when it issued its opinion in *Phillips v. County of Allegheny*, a Section 1983 action. The 3rd Circuit joined most courts in concluding, at least for the present, that the *Twombly* plausibility standard is not restricted to antitrust cases, but applies to the Rule 12(b)(6) standard generally, and in agreeing that the degree of factual detail required varies, depending on the type of case.

Admitting that it is "difficult to divine" whether the plausibility requirement "materially alters the notice pleading regime," the 3rd Circuit concluded that *Twombly* has not worked a change in the pleading standard of Federal Rule of Civil Procedure Rule 8(a), but rather re-enforces the rule's requirement that a pleading make a "showing" of entitlement to relief by including "enough facts to raise a reasonable expectation that discovery will reveal evidence of the necessary element."

The 3rd Circuit began its analysis by setting out three aspects of Rule 8 that the court concludes remain intact. First, *Twombly* does not require "detailed factual allegations," but "only a short and plain statement of the claim showing that the pleader is entitled to relief in order to give the defendant fair notice of what the claim is and the grounds upon which it rests." Second, on a Rule 12(b)(6) motion, the allegations must be taken as true and a complaint may not be dismissed because it appears unlikely that the plaintiff will prevail. Third, *Twombly* did not undermine the principal that reasonable inferences must be drawn in favor of the plaintiff.

Next, although the court initially suggested that *Twombly* introduced "two new concepts," it ultimately concluded that they spring from pre-existing principles. Acknowledging that its typical statement of the 12(b)(6) standard should no longer include the phrase that dismissal is not appropriate "unless it appears beyond doubt that plaintiff can prove no set of facts in support of his claim which would entitle him to relief," the 3rd Circuit reasoned that it has already "recognized principles that preclude the hyper-literal reading of *Conley's* language rejected in *Twombly*."

As for the *Twombly* court's concept that Rule 8 "requires a 'showing,' rather than a blanket assertion, of entitlement to relief," the 3rd Circuit joins the 7th Circuit in narrowly construing *Twombly* and *Erickson* together to mean that in context, "at some point, the factual detail in a complaint is so underdeveloped that it does not provide a defendant the type of notice of claim which is contemplated by Rule 8."

After raising the question of whether the numerous references in *Twombly* to "plausibility" materially alter notice pleading, the 3rd Circuit concluded that plausibility means setting out just enough facts to raise a reasonable expectation that discovery will reveal evidence of the necessary element. In this approach, the 3rd Circuit has apparently parted ways with the 2nd Circuit, which concluded in *Iqbal* that the Supreme Court obliges the plaintiff to plead enough facts where the context requires it "to render the claim plausible" and suggested that the degree of factual detail required may, in part, be driven by the extent to which the defendant might be burdened by broad-ranging discovery and litigation, 490 F.3d at 157-58, echoing a theme in *Twombly*.

The conservatism of the 3rd Circuit's

interpretation is illustrated by its application to the *Phillips* complaint. The *Phillips* action arose from the murder of Mark Phillips and his girlfriend, Gretchen Federbar, by Federbar's former boyfriend, Michael Michalski. The complaint, asserting claims under Section 1983 of violations of the Fourteenth Amendment's rights of due process and equal protection, as well as a violation of the Fourth Amendment, alleged that Michalski used his position as a dispatcher for the Allegheny County 911

Call Center to obtain information about Federbar and Phillips. Even after Michalski was suspended for this, two of his co-workers, who allegedly knew that Michalski was distraught over the end of his relationship with Federbar and had been suspended for using his position to access information about her and her new boyfriend, nevertheless used the call center's computers to help Michalski locate Phillips' home address and telephone number. Within a day, Michalski shot and killed Phillips and Federbar.

In a pre-*Twombly* decision, the district court granted a motion to dismiss the Section 1983 counts, holding that with respect to the due process claim, the complaint failed to state three of the four elements of a state-created danger cause of action. In particular, the court noted that the complaint did not allege where Phillips was shot, and reasoned that if Phillips was not shot in his home, then Phillips had not been made more vulnerable to harm because Michalski's two co-workers gave him Phillips' address and telephone number. Press reports of the crime indicate that the shootings, in fact, took place at Federbar's home.

Given the absence of an allegation that Phillips was shot at home, the factual allegation that Michalski's co-workers had

helped him obtain Phillips' home address and telephone number arguably could be deemed insufficient under the *Twombly* plausibility standard. In *Phillips*, however, the 3rd Circuit termed the district court's reasoning "an unduly crabbed reading of the complaint," adding, "[a]t this preliminary pleading stage, it is reasonable to infer that Michalski could have gained relevant information at Mark Phillips' house as to his whereabouts, which could have directly assisted Michalski in stalking and killing him." Characterizing its inference as a "reasonable" one to supply by implication the missing legal element of the claim, the *Phillips* court sustained the complaint.

Thus, *Phillips* indicates that as a practical matter, courts of the 3rd Circuit will continue to analyze 12(b)(6) motions according to the standards that they have long employed. Litigators, however, are well counseled to continue to avoid labels, conclusions and formulaic recitations of the elements of a cause of action, and to include enough facts to suggest, with the benefit of all reasonable inferences, that discovery will reveal evidence of each element of each claim.

As the 3rd Circuit's recent opinion in *Phillips* shows, the uncertainty noted by the 2nd Circuit has not been dispelled in the eight months since *Iqbal*.

To the contrary, the 3rd Circuit has observed that "[t]he issues raised by *Twombly* are not easily resolved" and has predicted that they "likely will be a source of controversy for years to come." After wrestling with what the 2nd Circuit has termed the Supreme Court's "not entirely consistent signals," the 3rd Circuit has conservatively interpreted *Twombly* as clarifying that Rule 8 cannot be satisfied by pleading legal conclusions or allowing a "hyper-literal" reading of the *Conley* maxim. In *Phillips* itself, the court filled in the gaps arguably present in plaintiff's complaint so that the case could proceed without much, if any, contextual analysis or attention to discovery issues.

The initial message of the 3rd Circuit is that not much has changed in pleading stands. It remains to be seen whether the Supreme Court agrees that only complaints so underdeveloped that fair notice is not provided to a defendant fall under *Twombly*.

Sharon McKee, a shareholder with Hangley Aronchick, also contributed to this article. •

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SEC

continued from L4

Subprime issues also have renewed the SEC's emphasis on its Consolidated Supervised Entity Program, which reviews the largest banks' quality of risk controls and liquidity. Investigations explore the strength of the banks' internal risk management systems and accounting issues, especially for off-balance sheet collateralized debt obligations. The SEC is also indicated an interest in investigating the adequacy of disclosures by subprime lenders.

Protecting senior investors is another chief priority for 2008. The SEC's stated goal is to identify effective practices for dealing with senior investors and to circulate them publicly.

Cox has stressed the need to "maximize the cutting-edge practices being developed by financial service firms to ensure that America's senior investors are being protected and well-served by brokers, investment advisors and others in the securities industry."

Some primary senior investigation topics include advertising and marketing; opening accounts; and suitability, surveillance and compliance.

In 2007, the SEC brought dozens of enforcement actions against those targeting seniors and caregivers. One massive senior fraud case against E-M Management involved more than 1,200 investors who attended "seminars" offering \$250 million in phony Las Vegas casino and resort telecommunications deals. The case reaffirmed the SEC's "commitment to take aggressive and forceful action against those who cause widespread harm through fraudulent securities offerings, particularly those who prey on the elderly," according to SEC Enforcement Chief Linda Thomsen.

Suspected insider trading, particularly by hedge funds and other large non-public investors, is third 2008 initiative. The SEC created a hedge fund working group to examine suspected insider trading, including by foreign-based hedge funds. This follows a recent 1st U.S. Circuit Court of Appeals ruling in *U.S. v. Tom*, that imprisonment (rather than probation) is appropriate for a hedge fund operator convicted

of insider trading.

The SEC filed 47 insider trading cases in 2007. Three hedge funds and 14 former employees at major securities dealers were charged in one huge suit with netting over \$15 million in illegal trading profits on thousands of trades based on stolen information — primarily analysts' upgrades/downgrades and acquisition announcements.

In other developments, SEC plans to investigate so-called 10b5-1 trading plans. These permit insiders at publicly traded companies to sell shares without being accused of insider trading. Their stock trades must be authorized in advance when confidential, non-public information is not used to affect the stock prices. According to Thomsen, the SEC may seek to discontinue the plans if it finds widespread abuses, that companies fail to take or prophylactic action to prevent future violations, or that they fail to take remedial action. Additionally, the Subprime Task Force is investigating whether insiders used nonpublic information in transactions involving complex debt-related derivatives, specifically in short selling such derivatives.

One final SEC initiative concerns stock option backdating — these probes are growing exponentially. The SEC created a potent stock option backdating working group of about 100 lawyers and accountants, and a recent report reveals the group's dramatic impact — over 220 companies have disclosed internal or federal investigations into employee stock option backdating to guarantee profits for option recipients. In 2006, the SEC filed only two stock option backdating cases; 24 were brought 2007. "There are still more to come," said Thomsen.

The tsunami of corporate scandals still captures public attention and inspires an aggressive, unforgiving law enforcement agency that plays by a unique set of rules. In 2008, the SEC will use its tools creatively to investigate potential securities violations involving the subprime industry, senior fraud, insider trading by hedge funds and stock options backdating. Prosecutions will be vigorous, swift and relentless. So rest assured — increased headaches are guaranteed for those subject to SEC enforcement in 2008. •

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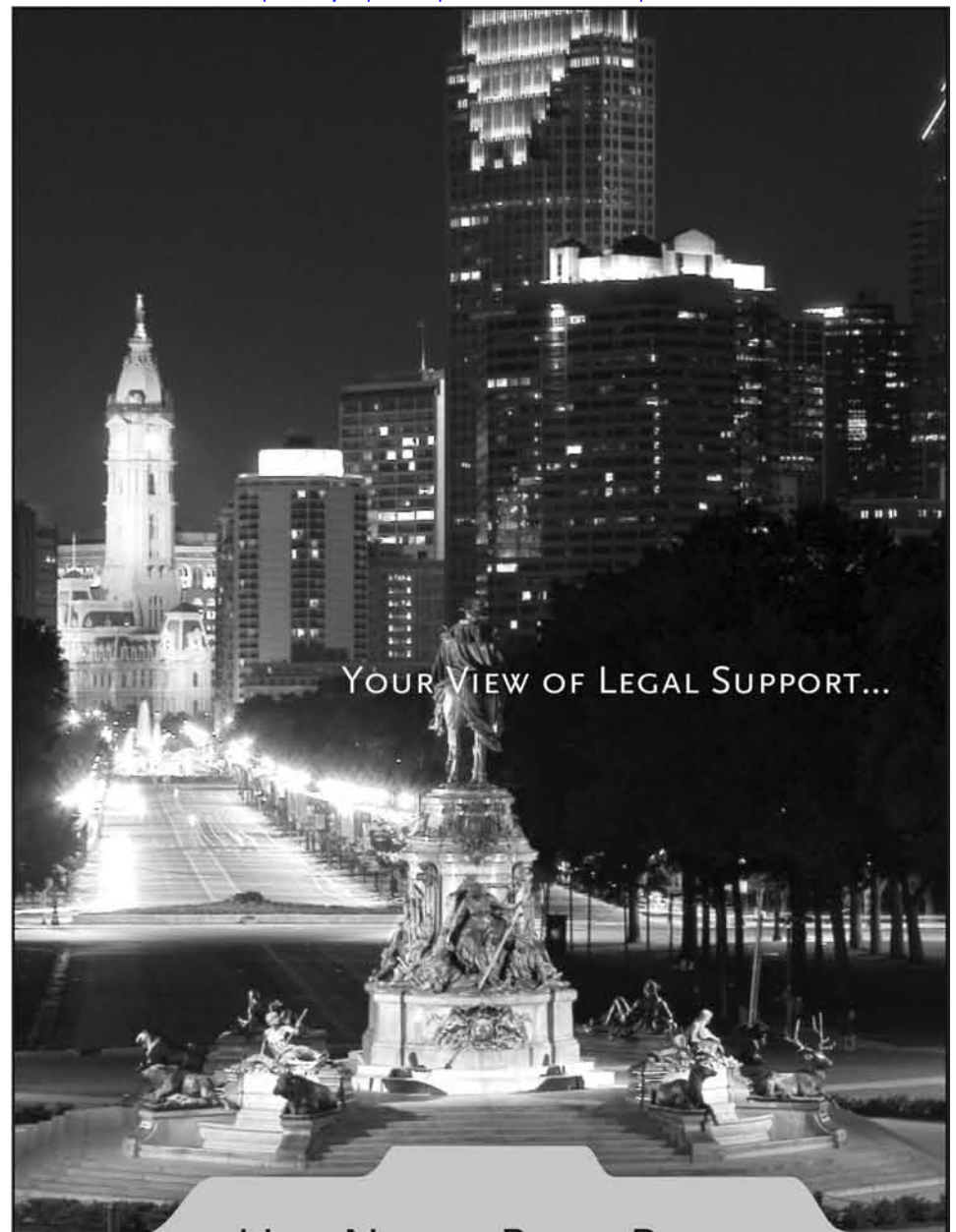
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