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COMMENTARY

California Supreme Court rejects attorney malpractice exception to mediation confidentiality
William A. Muñoz of Murphy, Pearson, Bradley & Feeney discusses the California Supreme Court’s recent decision in Cassel v. Superior Court and its effect on the scope of the state’s mediation-confidentiality rule.

MEDIATION CONFIDENTIALITY

Legal malpractice defendant rebuffed in pursuit of mediator’s testimony
A Pennsylvania federal judge has declined to review a decision by the clerk of the 3rd U.S. Circuit Court of Appeals refusing to permit the appeals court’s chief mediator to testify in a state court legal malpractice lawsuit.


Law firm McKissock & Hoffman had sought the mediator’s testimony in the hopes of refuting a former client’s claim that it committed malpractice by failing to pursue a $25 million settlement offer purportedly made during an appellate mediation.

But U.S. District Judge Mary A. McLaughlin of the Eastern District of Pennsylvania dismissed the law firm’s challenge to the appellate court clerk’s decision, concluding that the District Court lacked jurisdiction over the case.

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California Supreme Court rejects attorney malpractice exception to mediation confidentiality

By William A. Muñoz, Esq., Murphy, Pearson Bradley & Feeney

The mediation-confidentiality privilege has long been held sacrosanct by both the courts and legislature. Unfortunately, in 2009, the California 2nd District Court of Appeal, in Cassel v. Superior Court, attempted to eviscerate this confidentiality in a legal malpractice action arising out of alleged conduct and communications between an attorney and his client in an underlying trademark litigation. In that case, the 2nd District created an unwarranted attorney malpractice exception directly contrary to California Supreme Court precedent.

Although the California high court in Cassel confirmed the sanctity of mediation confidentiality, the case may have unintended consequences for the unwary practitioner in terms of how to advise a client wishing to resolve a case through mediation.

On Jan. 13, 2011, the California Supreme Court finally confirmed the sanctity of mediation confidentiality, even in a legal malpractice action, and reversed the 2nd District’s decision. While the Supreme Court’s decision certainly brings a collective sigh of relief to the legal community, practitioners must still remain cautious where mediation confidentiality is concerned.

The defense bar, and particularly those who have defended attorneys in legal malpractice actions based in whole or in part on what the attorney said, or did not say, during a mediation, unequivocally hail the Cassel decision as another tool to defend against claims of the proverbial “settle and sue” malpractice plaintiff unhappy with settlements in underlying cases.

However, the case may generate more litigation in terms of defining when communications are made “for the purpose of, in the course of, or pursuant to, mediation” by the plaintiff’s bar as a means to avoid the broad scope of mediation confidentiality.

More importantly, the case may have unintended consequences for the unwary practitioner in terms of how to advise a client wishing to resolve a case through mediation.

PRE-CASSEL TREATMENT OF THE MEDIATION PRIVILEGE

Prior to Cassel, the California Supreme Court and intermediate appellate courts had uniformly upheld, and strictly construed, the inadmissibility of statements or conduct occurring during mediation. This has included statements or conduct of counsel effectively precluding any claim for malpractice against the attorney.

In Wimsatt v. Superior Court, 152 Cal. App. 4th 137, 163 (Cal. Ct. App., 2d Dist. 2007), the plaintiff sued his attorneys for malpractice and breach of fiduciary duty after settling an underlying personal injury action, contending that the attorneys impermissibly reduced his settlement demand between the first and second mediation. Plaintiff discovered this issue in reviewing the mediation brief for the second mediation session.

In the malpractice action, plaintiff sought discovery of the mediation briefs and emails between his attorneys. The attorneys moved for a protective order, arguing that those communications were protected by mediation confidentiality. The trial court denied the motion. On appeal, the 2nd District reversed and issued a peremptory writ directing the court to vacate its order.

While recognizing the potential inequities and conflicting public policy of adhering to the Supreme Court’s strict construction of mediation confidentiality that would result in a client potentially relinquishing all claims for malpractice against his attorney arising out of conduct occurring at the mediation, the Wimsatt court stated:

Given that the number of cases in which the fair and equitable administration of justice has been thwarted, perhaps it is time for the Legislature to reconsider California’s broad and expansive mediation confidentiality statutes and to craft ones that would permit countervailing public policies be considered.

THE CASSEL DECISION

In August 2005 plaintiff Michael Cassel met privately with his attorneys to prepare for mediation and trial in a trademark dispute. Prior to the mediation, Cassel and his attorneys discussed not accepting less than $2 million. After 14 hours of mediation negotiations, during which the plaintiff did not feel well and had to leave to rest for a period of time, his attorneys called him back to the mediation, where he ultimately settled for $1.25 million.

Cassel then sued his attorneys for legal malpractice, alleging that the attorneys “forced” him to accept $1.25 million, rather than the higher amount he sought. He contended among other things that during the mediation, his attorneys threatened to withdraw from representing him on the eve of trial if he did not agree to settle the case under the auspices of a reduction in their fees.

Scan this code with your QR reader to see the California Supreme Court’s opinion in Cassel on Westlaw.
Before trial, the attorneys moved in limine to exclude evidence of conduct and conversations between them and Cassel that occurred while preparing for and at mediation. The trial court granted the motion.

The Court of Appeal granted Cassel’s writ petition, holding that mediation confidentiality did not apply to mediation-related communications between Cassel and his attorneys made outside the presence of the mediator and opposing party.

The majority based its holding largely on Evidence Code Section 1115, which defines “mediation” as a process whereby a neutral person “facilitates communication between the disputants to assist them in reaching a mutually acceptable agreement.” Because Cassel’s attorney was not a “disputant,” but operated together with Cassel as a “single party,” the court reasoned that their private conversations were not communications between disputants or between a disputant and the mediator that the mediation privilege was intended to protect.

Justice Dennis M. Perluss in his dissent disagreed with the majority’s holding, essentially arguing that the majority’s rule created an impermissible judicial exception to mediation confidentiality that was contrary to prior Supreme Court precedent.

The California Supreme Court reversed, relying upon the plain language of the mediation statutes, primarily Sections 1119 and 1122. Agreeing with Justice Perluss’ dissent, the court found that the 2nd District’s ruling created an impermissible judicial exception to the clear language of the mediation statutes.

According to the court, “the obvious purpose of the expanded language is to ensure that the statutory protection extends beyond discussions carried out directly between the opposing parties to the disputes, or with the mediator, during mediation proceedings themselves.”

Additionally, the court rejected the notion, as argued by Cassel, that mediation confidentiality, like the attorney-client privilege, is waived as between the attorney and client in a subsequent malpractice action. The court cited with approval to Wimsatt, supra, which held that mediation briefs and attorney emails sent in connection with mediation fell within the mediation privilege and that no “attorney malpractice exception” applied.

The court distinguished the policy behind the waiver of the attorney-client privilege under California Evidence Code Section 958 in the event of a malpractice action, with the confidentiality afforded by the mediation statutes.

The statutes, the court stated, “do not create a ‘privilege’ in favor of any particular person. ... Instead, they serve the public policy of encouraging the resolution of disputes by means short of litigation ... and are designed to provide maximum protection for the privacy of communications in the mediation context.”

As with its prior decisions addressing the scope of the mediation privilege, the Cassel court suggested any change to the mediation statutes must come from the Legislature, not the courts.

The court rejected the notion that mediation confidentiality, like the attorney-client privilege, is waived as between the attorney and client in a subsequent malpractice action.

As the court noted, “The Legislature decided that the encouragement of mediation to resolve disputes requires broad protection for the confidentiality of communications exchanged in relation to that process, even where this protection may sometimes result in the unavailability of valuable civil evidence.”

WILL THE LEGISLATURE CRAFT AN EXCEPTION?

In his concurring opinion, Justice Ming Chin noted the potential unintended consequences of the mediation statutes and the court’s ruling are a “high price to pay to preserve total confidentiality in the mediation process” because “attorneys will not be held accountable for any incompetent or fraudulent actions during mediation unless the actions are so extreme so as to engender a criminal prosecution against the attorney.”

While Justice Chin makes a good point, it is unlikely that the Legislature will amend the mediation statutes to avert this potential issue. Nor would mediation confidentiality necessarily apply in a hypothetical criminal proceeding contemplated by Justice Chin.

Certainly, there are bad attorneys and there will undoubtedly be occasions contemplated by Justice Chin that may very well occur. However, this is not the first statutorily created privilege that has been at odds with equitable policy reasons for which there has been an outcry to the Legislature to create an exception.

For instance, California’s litigation privilege, Cal. Civ. Code § 47, subdivision (b)(2), is one such privilege. The litigation privilege, much like mediation confidentiality, is deemed absolute.

In 2006, the California Supreme Court addressed the issue whether an abuse-of-process claim based upon an attorney’s noncommunicative acts in enforcing a default judgment was barred by the litigation privilege. The court held in the affirmative.

In so holding, the court recognized that the purpose of the litigation privilege was to permit free access to the courts and zealous advocacy without fear of derivative litigation. Of course, much like Justice Chin in Cassel, the court acknowledged that given the absolute nature of the privilege, some “shady characters” will be protected.

Despite the fact that the litigation privilege has been around for a number of years and numerous cases have addressed its applicability, the Legislature has not changed it or created exceptions thereto. The same holds true with mediation confidentiality.

On those occasions over the past 10 years when the California Supreme Court has addressed mediation confidentiality, it has routinely indicated that any exception to the mediation-confidentiality rule must come from the Legislature. However, despite this pronouncement, or invitation to do so, the Legislature has remained silent. The reason appears fairly simple.

Evidence Code Section 1122 has a mechanism by which the confidentiality can be waived: All participants must agree to it in writing. Similarly, fewer than all of the parties can waive the privilege relating to an oral or written communication prepared solely for their benefit, but only if the communication...
does not disclose anything said or done in the course of the mediation.20

While at first blush, this latter provision may provide a loophole for the malpractice plaintiff to admit evidence of communications with his or her attorney for purposes of supporting a malpractice claim, the clear import of the language precludes such evidence because it would disclose what was said or done in the mediation.

The idea that the Legislature will create an attorney malpractice exception to permit a client to sue his or her attorney following a mediation because the client felt pressured to settle for less than he or she would have otherwise wanted flies in the face of the salutary purposes of mediation in resolving lawsuits and reducing already overburdened court dockets.

Moreover, given that the courts are already suspect of speculative malpractice claims in which plaintiffs routinely argue that but for the attorney’s negligence or wrongful conduct, they would have achieved a better result (i.e., higher settlement or more favorable jury verdict), the likelihood of such an exception in light of the overriding policy reasons for mediation confidentiality is negligible, at best.

WHAT THE POST-CASSEL PRACTITIONER MUST BE AWARE OF

Notwithstanding the sound policy reasons enunciated by the Cassel court, attorneys must be aware of the potential negative implications of this ruling. The obvious issue is what advice do you give a client in terms of trying to resolve a case through mediation. As noted by Justice Chin in his concurrence, what attorney would agree to waive mediation confidentiality under any circumstances?

Obviously, the attorney, on the one hand, wants the protection of the mediation privilege to shield the attorney from any potential liability that could arise during mediation, whereas the client, on the other hand, may wish to expeditiously try to resolve the matter short of trial.

The Cassel decision may present a potential conflict of interest between the attorney and client as the attorney is arguably putting his or her own interests (immunity from mediation-based malpractice claims) over that of the client in seeking a cost-effective resolution to the matter at hand.

Arguably, the Cassel decision may require an attorney counseling a client considering mediation to advise the client of the following:

• All communications and documents relating to or occurring during the mediation are confidential absent a waiver by all parties.

• All communications or documents relating to or occurring during the mediation are not admissible and cannot be used to support a civil claim against any party to the mediation, including the attorney for malpractice.

• Whether the attorney plans to waive mediation confidentiality.

• If the attorney does not plan to waive mediation confidentiality, then the client should be advised to seek advice of independent counsel.

The idea that the Legislature will create an attorney malpractice exception flies in the face of the salutary purposes of mediation in resolving lawsuits and reducing already overburdened court dockets.

While the Cassel decision in theory suggests that attorneys may need to provide the aforementioned advice or disclosures, such an argument runs counter to the court’s strict adherence to and broad scope of the mediation privilege.

The mere fact that the attorney did or did not advise the client about the possible pitfalls of agreeing to mediation falls squarely within the web of the mediation-confidence provision itself as “for the purpose of, in the course of, or pursuant to, a mediation.” It can hardly be argued that advising a client about the mediation process itself is not “materially related to, and fosters, the mediation.”21

The burden will be upon the attorney seeking to invoke mediation confidentiality to establish its applicability.22 Since the Cassel decision, one court has demonstrated the one issue that will likely continue to be litigated regarding mediation confidentiality: whether a communication was “prepared for the purpose of, in the course of, or pursuant to, a mediation or a mediation consultation.”23

That case, although not a legal malpractice action, involved the highly publicized departure of Hewlett-Packard’s former chief executive officer amid allegations of inappropriate conduct with an independent contractor. The issue presented was whether a pre-litigation demand letter that did not mention mediation, and that was prepared when the parties were not engaged in mediation, was nonetheless protected from disclosure by the mediation privilege.

Although the letter at issue in the case was sent for purposes of inviting settlement discussions, the court distinguished Cassel and rejected the argument that the letter was cloaked with mediation confidentiality.24

Consequently, in order to stay within Cassel’s protective scope, best practices would dictate that the attorney shouldpreface any communication relating to mediation with language clearly indicating that the advice and content of the correspondence relates to the mediation.

Along the same lines, when orally discussing mediation or mediation strategy with a client, the attorney should confirm the discussion in writing, again clearly indicating the discussion was about the mediation.

Lastly, the attorney should maintain good billing records indicating discussions with the client or third parties about the mediation in order to garner the benefits of the Cassel decision.

CONCLUSION

The Cassel decision is a great victory for the defense bar and attorneys in general. Unfortunately, plaintiff’s counsel will undoubtedly continue to litigate the scope of “for the purpose of, in the course of, or pursuant to, a mediation” as a means to avoid the preclusive effect of Cassel and mediation confidentiality.

It is unlikely that the California Legislature will create an attorney malpractice exception to mediation confidentiality given the overwhelming policy reasons favoring informal resolution of cases and the less common egregious attorney conduct during mediation contemplated by Justice Chin in his concurrence.
Until such time as the Legislature determines that a statutory exception for legal malpractice claims is warranted, the Cassel decision will be a useful shield to defend against claims from the “settle and sue” plaintiffs and their attorneys.

NOTES

2 Cassel v. Super. Ct., 51 Cal. 4th 113 (Cal. 2011).
3 Cal. Evid. Code § 1119(a); see also Robert K. Sall, Ethical Concerns Regarding Mediation Confidentiality and the Implications of Cassel, 53 Orange County Lawyer 42, 43-44 (April 2011).
5 Wimsatt, 152 Cal. App. 4th at 159.
6 Id. at 164.
7 Cassel, 179 Cal. App. 4th at 158-162.
8 Id. at 165-166 (Perluss, J., dissenting).
9 Cassel, 51 Cal. 4th at 128.
10 Id. at 133.
11 Id. at 133-134; Wimsatt, 152 Cal. App. 4th at 163.
12 California Evidence Code Section 958 states, “There is no privilege under this article as to a communication relevant to an issue of breach, by the lawyer or by the client, of a duty arising out of the lawyer-client relationship.”
13 Cassel, 51 Cal. 4th at 132 (citations omitted).
14 Id. at 136; see also Simmons, 44 Cal. 4th at 580; Foxgate, 26 Cal. 4th at 13-14; Wimsatt, 152 Cal. App. 4th at 163.
15 Cassel, 51 Cal. 4th at 138 (Chin, J., concurring).
18 Rusheen v. Cohen, 37 Cal. 4th 1048 (Cal. 2006).
20 Id.
21 Wimsatt, 152 Cal. App. 4th at 160.
22 Id. at 161-162.

William A. Muñoz is a shareholder in the Sacramento, Calif., office of Murphy, Pearson, Bradley & Feeney. He is a member of the professional liability committee of defense attorney association DRI and the American Bar Association’s Lawyers Professional Liability Consortium. Muñoz focuses his practice primarily on the defense of attorneys and other professionals in professional negligence and breach-of-fiduciary-duty matters.

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Law firm swings, misses in bid to prevent suit by Dodgers owner

A Boston law firm cannot use the declaratory judgment procedure as a means of warding off a potential malpractice suit by Los Angeles Dodgers owner Frank McCourt, a Massachusetts judge has ruled.


Judge Janet L. Sanders of the Suffolk County Superior Court dismissed Bingham McCutchen LLP’s request for a ruling that it did not botch a marital agreement between McCourt and his estranged wife, finding no precedent for allowing an alleged tortfeasor to “preemptively sue the alleged victim.”

According to the judge’s order, Bingham attorney Lawrence Silverstein drafted a marital property agreement for McCourt and his wife, Jamie, in 2004 in anticipation of McCourt’s acquisition of the Dodgers and the couple’s move from Massachusetts to California.

When the McCourts later became involved in a divorce, it came to light that some copies of the agreement listed the team as Frank McCourt’s sole property, while others stated “precisely the opposite,” the order says. According to the judge, the complaint does not explain the discrepancy between the different versions.

In December 2010, the California state judge in the divorce case invalidated the agreement, saying there was insufficient evidence of a “meeting of the minds” because of the conflicting versions of the agreement.

Since that time, Frank McCourt has repeatedly threatened to sue Bingham for malpractice, according to the order, citing Bingham’s declaratory judgment complaint. McCourt contends that Bingham’s work on the marital property agreement provided his wife with “a credible claim that she owns 50 percent of the Dodgers.”

In April Bingham filed this declaratory judgment action, asking the court to rule that the legal services Silverstein had performed met the applicable standard of care.

But Judge Sanders concluded that a suit for a declaration that an attorney did not commit malpractice is not an appropriate use of the declaratory judgment procedure.

“To permit the reversal of roles in a negligence action and to allow the [alleged] tortfeasor to sue first would upset the traditional right that our judicial system gives to the injured plaintiff to choose when and where to litigate,” the judge said.

“The declaratory judgment procedure has never been used in Massachusetts to allow an individual or entity accused of a tort to preemptively sue the alleged victim,” the judge said.

For this reason, “courts in virtually every state ... have declined to allow an individual or entity accused of a tort to use the declaratory judgment procedure to beat the alleged victim of the tort to the courthouse,” she said.

Judge Sanders said the advantage of choosing the forum and timing of a potential malpractice claim is particularly important in this situation, given McCourt’s multiple legal battles in different states.

In addition to the contentious divorce proceedings in California, McCourt is in the midst of battling Major League Baseball over his ownership of the Dodgers, the judge noted.

**Attorneys:**

**Plaintiff:** Michael B. Keating, Foley Hoag, Boston

**Defendant:** Thomas F. Reilly, Cooley Manion Jones, Boston

**Related Court Document:** Memorandum of decision and order: 2011 WL 3621873

See Document Section B (P. 25) for the decision and order.
The malpractice suit, pending in the Philadelphia County Court of Common Pleas, stems from McKissock & Hoffman’s representation of Polymer Dynamics Inc. in a federal breach-of-contract action against Bayer Corp.

After a lengthy litigation that included an appeal to the 3rd Circuit, Polymer Dynamics was awarded $12.5 million.

Dissatisfied with the award, Polymer Dynamics then sued McKissock & Hoffman for malpractice for allegedly failing to recommend that the company accept a settlement offer for twice that amount, which Polymer claims was presented during appellate mediation.

Polymer Dynamics asserts in the malpractice suit that during the mediation, 3rd Circuit chief mediator Joseph Torregrossa indicated that a $25 million settlement offer was on the table, according to McKissock & Hoffman’s District Court complaint.

But the law firm has denied that any such settlement offer was ever made and, in an attempt to back up its denial, requested permission to depose Torregrossa.

Marcia Waldron, the 3rd Circuit clerk, denied the firm’s request, saying testimony from Torregrossa about the mediation “would eviscerate the vital principle of confidentiality and damage the integrity and viability of the court’s mediation program,” the firm’s complaint says.

McKissock & Hoffman then sued Waldron, alleging that her refusal to permit the chief mediator’s testimony violated the Administrative Procedure Act, 5 U.S.C. § 701.

The APA allows federal courts to review “agency action” but specifically exempts “the courts of the United States” from judicial review.

Waldron filed a motion to dismiss for lack of jurisdiction, contending that as 3rd Circuit clerk, she is part of the federal judiciary and thus exempt from review under the APA.

Judge McLaughlin agreed, saying “the legislative history of the APA supports a broad interpretation of ‘the courts’ that includes the entire judicial branch.”

Given the legislative history and the fact that Waldron is bound by 3rd Circuit rules and supervised by the court’s judges, Judge McLaughlin determined that Waldron is part of “the courts” as opposed to an “agency.” Consequently, McKissock & Hoffman cannot proceed with its challenge to Waldron’s decision under the APA, the judge concluded.

**The Administrative Procedure Act**

McKissock & Hoffman sought review of the 3rd Circuit clerk’s decision by way of the Administrative Procedure Act, which affords a right of judicial review to anyone “adversely affected or aggrieved by agency action.” The APA, 5 U.S.C. § 701(b)(1), states in relevant part:

“‘Agency’ means each authority of the government of the United States, whether or not it is within or subject to review by another agency, but does not include ... the courts of the United States.”

**Attorneys:**

**Plaintiff:** Jeffrey B. McCarron, Swartz Campbell & Detweiler, Philadelphia

**Defendant:** Richard M. Bernstein, U.S. attorney’s office, Philadelphia

**Related Court Documents:**

Opinion: 2011 WL 3438333

Order: 2011 WL 3438263

*See Document Section A (P. 21) for the opinion and order.*
New lawyer off the hook for failing to undo prior missed deadlines

An attorney who took over the defense in an employment discrimination case did not commit malpractice by failing to withdraw admissions that stemmed from an earlier lawyer’s representation of the defendant employer, a Texas appeals court has ruled.


The employer failed to establish that had the second lawyer filed a motion to withdraw the admissions in the underlying case, the trial court would have granted the motion, the Court of Appeals in Dallas said.

In the underlying lawsuit, Melissa Baker accused a bar owner of unlawful discrimination by firing her from her bartending job allegedly because she was pregnant.

According to the panel’s opinion, the bar’s owner, Tommy Gio Inc., hired attorney Michael Stephens in July 2007 to defend it against Baker’s employment discrimination lawsuit.

Baker immediately served Stephens with a request for admissions.

In November 2007 Tommy Gio hired Stacy Dunlop to replace Stephens as its attorney in the lawsuit.

Dunlop subsequently learned that Tommy Gio had never responded to the July 2007 admission requests.

Under Texas procedural rules, a request for admissions is required to be answered within 30 days. The request is automatically deemed admitted if there is no response by the date the answers are due.

Dunlop asked Baker’s attorney for an extension of time to respond and to agree not to oppose a motion to “undeem” the admissions, but Baker’s counsel refused both requests, and the case proceeded to trial.

At trial, the judge ruled that because no response to the admissions request had been served and no motion to set aside the “deemed” admissions had been filed, all statements in Baker’s request for admissions were considered admitted by Tommy Gio.

The statements that were deemed admitted included admissions that the bar owner fired Baker because she was pregnant and that the owner was an “employer” within the purview of the antidiscrimination law — essential elements of Baker’s discrimination claim.

The trial court went on to conclude that Baker was unlawfully terminated and entitled to damages.

Tommy Gio then sued Stephens and Dunlop for malpractice in the Dallas County District Court.

“We conclude that appellants did not conclusively establish as a matter of law that the outcome of the ... [underlying] lawsuit would have been different if appellees had filed a motion to undeem the admissions,” the appeals court said.

The Court of Appeals disagreed.

To prevail on a motion to set aside deemed admissions, Tommy Gio would have had to show that the request for admissions was not answered because of accident or mistake, the panel said.

But at the malpractice trial in this case, no evidence was presented of any accident or mistake on Stephens’ part, the appellate court noted.

Thus, it could not be said that had Dunlop filed a motion to withdraw the admissions, the trial court in Baker’s case would have granted the motion, the panel said.

Consequently, Tommy Gio failed to meet its burden of proving that Dunlop’s failure to file the motion caused the company to lose the underlying lawsuit, the panel concluded, affirming the lower court’s ruling.

Attorneys:
Plaintiff: T. Craig Sheils, Sheils Winnubst P.C., Richardson, Texas
Defendant: Stacy A. Dunlop, Dunlop Law Firm, Dallas

Related Court Document:
Opinion: 2011 WL 3528191

See Document Section C (P. 29) for the opinion.
The homeowner could not prove architectural malpractice because the architect had no involvement with the homeowner’s decision to substitute engineered-wood structural materials for the conventional lumber specified in the architect’s plans, the panel determined.

According to the opinion, Steven Bruno hired architect Joseph Galea to draw up plans for a home to be built in Putnam Valley, N.Y.

Galea’s architectural plans called for the use of traditional wood for the joists and beams that provide support for the floors of a structure. The Putnam Valley residential building department approved the plans.

Subsequently, Bruno decided to use the “Trus Joist” framing system of engineered-wood joists and beams, containing composite-wood materials, instead of the conventional wood framing materials specified in Galea’s plans.

Galea asserted in an affidavit that once his plans obtained the municipality’s approval, he had no further involvement with the project and that Bruno later decided on his own to switch materials.

Shortly after Bruno and his family moved into the new home, cracks developed in the stone and ceramic tile flooring installed throughout much of the first floor.

Bruno filed suit in the Putnam County Supreme Court, accusing Galea of architectural malpractice. Also named as defendants were Trus Joist a Weyerhaeuser Business, which manufactured the products used for the framing system in the house, and product supplier Lakeland Lumber Co.

Galea filed a motion for summary judgment, arguing that his services were neither a departure from accepted standards of architectural practice nor the proximate cause of the flooring problems.

A claim of architectural malpractice requires proof of both elements.

The architect asserted he did not even realize that engineered wood was used instead of traditional wood until he visited the house more than a year after its completion.

That visit also was the first time Galea learned Bruno had installed flooring consisting of heavyweight stone and tile rather than the standard materials upon which his structural plans were based, according to the affidavit.

Galea theorized that the changes to his plans might have compromised the home’s structural integrity, thus causing the floor cracks.

The lower court granted summary judgment to Galea, citing Bruno’s “unilateral decisions to change the design and structural load bearing.”

Bruno appealed, disputing Galea’s claim that he had no prior knowledge of Bruno’s desire to use engineered wood joists and heavyweight flooring materials.

On appeal the Supreme Court Appellate Division, 2nd Department, said it made no difference what Bruno might have told Galea before the plan’s completion because it was undisputed that Galea’s final, approved plan specified the use of wood joists.

Therefore, Bruno failed to raise a triable fact issue that Galea negligently performed his architectural services or caused the floor problems, the panel concluded.

It affirmed the dismissal of the malpractice claims. 

Attorneys:

Plaintiff: Timothy B. Cummiskey, Goetz Fitzpatrick, New York

Defendant: Seth D. Cohen, Brand Glick & Brand, Garden City, N.Y.

Related Court Document:

Opinion: 2011 WL 3715532

See Document Section D (P. 38) for the opinion.
Mortgage brokerage owner charged in $58 million fraud conspiracy

Federal prosecutors in New York have charged a mortgage brokerage’s top executive and 13 alleged co-conspirators in a “brazen and wide-ranging scheme” that garnered more than $58 million from scores of fraudulent loans.

**United States v. Canino et al., No. 1:11-cr-00655-RPP, indictment filed (S.D.N.Y. Aug. 4, 2011).**

A five-count indictment, filed Aug. 3 in the U.S. District Court for the Southern District of New York, accuses Gerard Canino, president and owner of First Class Equities, of bank fraud and conspiracy to commit wire fraud, the Manhattan U.S. attorney’s office said in a statement.

In addition to Canino the indictment charges five loan officers, four practicing attorneys, one disbarred attorney and three others.

The defendants allegedly targeted about 100 property owners in New York City, Westchester County and Long Island who were struggling to make mortgage payments.

After identifying residential properties in financial distress, the defendants allegedly recruited individuals, including current and former spouses, family and friends, to act as “straw buyers” to buy the homes.

The straw buyers never intended to live in or pay for the mortgaged homes, prosecutors said. Some of the straw buyers allegedly were paid a fee for their services.

According to the indictment, the defendants submitted fraudulent loan applications on behalf of the straw buyers in order to obtain mortgages from various lenders. The applications allegedly gave false information about the straw buyers’ income and net worth.

Loan proceeds were routed to an escrow account controlled by one of the conspirators, the charges say. One of the conspirators would then disburse the funds from the escrow account to other conspirators, according to the indictment.

After finalizing a home sale, a straw buyer would give up control of the property, sometimes by “flipping” the property for a higher price to a second straw buyer using another fraudulently obtained mortgage, prosecutors say.

Canino often made mortgage payments for a few months on properties the conspirators did not flip, keeping the lending institutions from suspecting mortgage fraud, the indictment says.

Eventually the defendants would let the fraudulent mortgages default, and the properties would end up in foreclosure, it says.

“This brazen and wide-ranging scheme defrauded banks and lenders of millions and enriched its participants, including real estate professionals who took advantage of their inside knowledge of the system to fleece it,” Manhattan U.S. Attorney Preet Bharara said in the statement.

Canino could serve up to 90 years in federal prison and be fined up to $3 million if found guilty. The other defendants each face up to 30 years in prison and $1 million in fines if convicted.

<table>
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<tr>
<th>Defendant</th>
<th>Residence</th>
<th>Age</th>
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<tr>
<td>Gerard Canino</td>
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<td>Ian Katz</td>
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<td>Pandora Bacon</td>
<td>Newark, N.J.</td>
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OFFICERS AND DIRECTORS

First-impression ruling says appraisal not sole post-merger remedy

On an issue of first impression, a divided federal appeals court in Philadelphia has revived a challenge to the buyout of insulation manufacturer Irex Corp. after finding that a petition for stock appraisal was not the only post-merger remedy available to “squeezed-out” shareholders.


In a 2-1 decision, the majority of the 3rd U.S. Circuit Court of Appeals reversed the dismissal of shareholder Mitchell Partners L.P.’s federal court suit in Pennsylvania.

The suit charged that the Irex officers disloyally handed over control of the company to a buyout group under the table. That made a later shareholder vote on the sale moot, the suit said.

FREEZE-OUT OPTIONS

The ruling is important because the 3rd Circuit decided for the first time whether disgruntled shareholders could file a post-merger breach-of-duty lawsuit in Pennsylvania federal courts or whether the dissidents were limited to an appraisal action.

When Mitchell Partners brought its breach-of-duty suit in the U.S. District Court for the Eastern District of Pennsylvania, the state Supreme Court had not addressed the issue of whether appraisal is the only available post-merger remedy for frozen-out shareholders.

The District Court decided that the appraisal statute did not allow for this suit and dismissed it.

Therefore, when the plaintiff appealed that decision, the 3rd Circuit was forced to predict what the Pennsylvania Supreme Court would decide if it were presented with the question.

Judge Dolores Sloviter, writing for the majority of the three-member appellate panel, said it was highly unlikely that Pennsylvania would limit shareholder challenges to simple appraisal actions, even after the merger, because wrongdoing sometimes comes to light only after the merger.

GOING THROUGH THE MOTIONS

Mitchell’s 2008 suit alleged that Irex’s top officers conspired to give buyout group North Lime Holdings Inc. virtual control of Irex by secretly swapping their Irex shares for North Lime stock.

With a supermajority of Irex stock in hand, North Lime was able to conduct a freeze-out merger.

The suit also claimed that the Irex directors and officers conspired with the buyout group to keep the purchase price unfairly low.

Mitchell charged that although the Irex board went through the motions of creating a special committee of directors to review the fairness of the offer, the committee was from the beginning influenced by company insiders who had engineered the deal.

CLAIMS BARRED

The Pennsylvania federal court found that the suit stated well-supported claims that the Irex officers and directors had breached their duty to get the best price for the company.

Nevertheless, it dismissed the action on grounds that the only type of suit Pennsylvania allows a shareholder to file after a freeze-out merger is an appraisal action.

How the appraisal statute works

A shareholder who acquires an overwhelming majority of a company’s stock is permitted to force the remaining public shareholders to sell their stock in what is called a “freeze out” or “squeeze out” merger.

The appraisal statutes of some states allow those frozen-out shareholders who believe they were cheated to challenge that action only by asking the court to set the fair value of their stock.

Other states allow those shareholders to file breach-of-duty charges in an attempt to prove that the defendants used fraud or disloyal actions to set up and implement the freeze-out at an unfairly low price.
On appeal, the 3rd Circuit majority said that since Pennsylvania’s high court had not yet ruled on the issue, the appellate panel would have to interpret the murky wording of the state’s appraisal statute.

The majority found that the appraisal action is not the exclusive remedy in this case because the Pennsylvania courts had decided, in related matters, that “separate and distinct causes of action may be pursued as a result of the same purchase offer.”

The appraisal statute also leaves unresolved the meaning of “fraud and fundamental unfairness,” which could provide an exception to the appraisal-only requirement, the majority said.

The majority predicted that the Pennsylvania Supreme Court would allow other types of post-merger shareholder actions in addition to appraisal.

### The 3rd Circuit’s prediction

The majority predicted that Pennsylvania’s high court would allow other types of post-merger actions because:

- Previous rulings by the state’s courts have barred adding other charges in appraisal actions, but none have banned separate actions making other charges.
- Nothing in the appraisal statute distinguishes between pre- and post-merger actions.
- The appraisal statute applies only to suits against corporate entities, not to suits against directors and officers as is the case here.
- The damages that can be sought in an appraisal action are more limited than those that can be sought in a breach-of-duty action.
- The appraisal remedy is limited to those who have officially objected to the buyout price before the deal closed, thus unfairly excluding those who became aware of self-dealing after it closed.
- The “fraud or fundamental unfairness” exceptions likely include the type of self-dealing alleged here.

### NO SHIELD FOR MISCONDUCT

The majority concluded that the suit was improperly dismissed because the appraisal statute “was hardly enacted to provide a shield for misconduct.”

In dissent, Judge Leonard Garth said the Pennsylvania Legislature had made appraisal the exclusive remedy and had not seen fit to amend that law.

He said the majority was unduly influence by Delaware’s decision to amend its appraisal statute to allow other types of actions. 

**Attorneys:**
- **Appellant:** George Croner, Kohn, Swift & Graf, Philadelphia
- **Appellees:** Steven Feirson, Dechert LLP, Philadelphia

**Related Court Document:**
- Opinion: 2011 WL 3841007

This reporter covers the proliferation of the class action lawsuit in numerous topic areas at the federal, state, and appeals court levels. Topics covered include consumer fraud, securities fraud, products liability, automobiles, asbestos, pharmaceuticals, tobacco, toxic chemicals and hazardous waste, medical devices, aviation, and employment claims. Also covered is legislation, such as the 2005 Class Action Fairness Act and California’s Proposition 64, and any new federal and state legislative developments and the effects these have on class action litigation.
Heavy *scienter* burden sinks securities suit against shipping line

A split panel of the 3rd U.S. Circuit Court of Appeals has applied a strict reading of the “weighty” *scienter* requirement of the toughened securities law pleading standards in refusing to revive charges that Horizon Lines officers secretly used price-fixing to buoy the shipping company’s profits.


The two-judge majority upheld the dismissal of securities fraud charges against the Horizon officers because there was insufficient proof that they made misleading statements with the intent to deceive investors.

**A WEIGHTY BURDEN**

The majority noted that the Private Securities Litigation Reform Act of 1995, Pub. L. 104-67 “places a weighty burden on plaintiffs.”

Here, the panel said, “plaintiff did not plead sufficient facts, when viewed in their totality, to raise a strong inference of *scienter* as to the senior executives.”

The PSLRA was Congress’ attempt to weed out the nuisance lawsuits often filed by opportunistic shareholder attorneys when bad news caused a company’s stock price to drop.

The law required shareholder plaintiffs to allege charges that were sufficiently supported to survive a motion to dismiss before they could move forward with discovery.

Among other things, that meant that they had to show that the allegedly misleading statements at the heart of the suit were intended to deceive shareholders and were the cause of their economic losses.

**BAD NEWS SURFACES**

In this case, various pension funds asserted in the U.S. District Court for the District of Delaware that the value of their investments in Horizon Lines dropped when news of price-fixing surfaced in April 2008 after the FBI executed search warrants on the company.

Horizon is based in Charlotte, N.C., and incorporated in Delaware.

According to court records, Horizon and three of eight executives involved in that scheme pleaded guilty to price-fixing, but no criminal charges were filed against the other five.

**THE REAL PROFIT BOOSTER**

The plaintiffs alleged Horizon executives deceived investors into believing that superior business strategy was the reason for a spike in revenue when it was really price-fixing that temporarily boosted profits.

The Delaware District Court judge dismissed the suit, however, after finding that although the allegations were well supported, there was insufficient evidence that the executives made the purportedly misleading statements “in a knowing or reckless state of mind” regarding the truth.

**AN EXTREME DEPARTURE**

On appeal, Judge Maryanne Barry, writing for the majority, found that the standard for *scienter* is high and the District Court correctly decided that the plaintiffs did not meet it.

“A reckless statement is one involving not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care,” Judge Barry wrote. “Allegations akin to corporate mismanagement are not sufficient.”

In dissent, Judge Thomas Ambro said the PSLRA does not require that each allegation in a complaint be sufficiently well supported to stand on its own; it only requires that the charges, taken in their totality, be well-supported enough to strongly infer *scienter*.

Judge Ambro said the totality of the charges is sufficient to withstand a motion to dismiss.

**Attorneys:**

Appellants: John Browne, Bernstein, Litowitz, Berger & Grossmann, New York

Appellees: Paul Lockwood, Skadden, Arps, Slate, Meagher & Flom, Wilmington, Del.

**Related Court Document:**

Opinion: 2011 WL 3695897
Bad collateral meant bad news for stock price, suit says

When the stock market found out that nearly half of the $97 million in collateral for margin loans that Penson Worldwide made to investors was virtually worthless, the finance industry firm’s share price plummeted, a federal securities fraud suit in Dallas has charged.


The suit says Penson officers artificially inflated the stock price of the Dallas-based financial services support firm by hiding news that it was unlikely to collect interest on margin loans to customers using subprime real estate and related securities as collateral.

One of Penson’s chief sources of income was the interest it received on margin loans it made to enable investors to bet large amounts on stocks.

The firm’s stock price dropped by nearly 30 percent between May 9 and May 11 after the announcement, blindsiding investors who had been deceived by rosy fiscal forecasts by company officers, Friedman says.

The suit claims that CEO Philip Pendergraft and CFO Kevin McAleer violated federal securities laws by knowingly authoring false and misleading statements about the security of Penson’s margin loans and the revenue that could be expected from them.

They had direct and supervisory involvement in the day-to-day operations of the company and knew or should have known the statements were false and that they would injure investors, the suit alleges.

Penson’s stock price dropped by nearly 30 percent between May 9 and May 11 after the disclosure, blindsiding investors who had been deceived by rosy fiscal forecasts, the suit says.

The suit charges violations of Securities and Exchange Commission Rule 10b-5, which covers alleged fraud in the sale of securities.

Friedman asks the court to hold the officers individually liable for any economic damage the shareholders suffered.

Attorneys: Plaintiff: Ryan R. C. Hicks and Peter Schneider, Schneider Wallace Cottrell Brayton Konecky LLP, Houston; Laurence D. King, Kaplan Fox & Kilsheimer, San Francisco; Frederic S. Fox and Jeffrey P. Campisi, Kaplan Fox & Kilsheimer, New York

Related Court Document: Complaint: 2011 WL 3681729
SEC charges brokerage with defrauding school districts

A St. Louis-based brokerage firm and an executive defrauded five Wisconsin school districts out of millions of dollars by misrepresenting the safety of a series of complex investments, the Securities and Exchange Commission has alleged.


The investments ultimately proved to be a complete failure, but the defendants allegedly collected “significant” fees, the SEC says.

In a complaint filed in the U.S. District Court for the Eastern District of Wisconsin, the agency alleges Stifel, Nicolaus & Co. and now-former senior vice president David W. Noack created an unsuitable, high-risk investment program to help the school districts fund retiree benefits.

The success of the program depended on the performance of complex securities known as “synthetic collateralized debt obligations” consisting of credit default swaps on corporate bonds, the SEC says.

The securities in essence were wagers that the bonds would hold their value as reflected in periodic credit ratings.

To invest in the CDOs, the school districts established a $200 million trust. They contributed $37.3 million and borrowed the rest to cover three investment transactions from June to December 2006, the complaint says.

The defendants knew the school districts were risk-averse and that the preservation of capital was their primary goal, the suit says.

The defendants allegedly made “sweeping assurances” such as it would take “15 Enrons” for the investments to fail and that an economic catastrophe resulting in “breadlines” would have to occur before the districts would lose their money.

From the outset the defendants allegedly hid the investments’ poor performance from the school districts, which had no prior experience investing in CDOs, the suit says.

The value of the investments steadily declined in 2007 and 2008 as the CDOs suffered a series of downgrades, the complaint says.

The school districts ultimately lost their entire investment and received credit rating downgrades themselves.

The SEC accuses the defendants of violating Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. It seeks disgorgement of the fees generated by the defendants and fines.

Attorney:
Plaintiff: Steven C. Seeger, SEC, Chicago

Related Court Document:
Complaint: 2011 WL 3482051
INVESTMENT FRAUD

Dreier trustee loses bid to avoid Wachovia repayments

The trustee for disgraced lawyer Marc Dreier’s failed law firm has been turned away by a bankruptcy judge in her effort to avoid liens and recover funds the firm paid to Wachovia Bank.


Judge Stuart M. Bernstein of the U.S. Bankruptcy Court for the Southern District of New York said trustee Sheila Gowan adequately pleaded that Wachovia loan proceeds were used in Dreier’s Ponzi scheme. However, the judge dismissed the adversary proceeding against the bank because the complaint failed to allege Wachovia made the loans with knowledge of the illegal scheme.

“Wachovia may have been guilty of bad banking, but the complaint fails to allege that it had actual or constructive knowledge of [Dreier’s] fraudulent scheme,” Judge Bernstein wrote.

The complaint failed, however, to allege sufficiently that Wachovia was aware of the scheme.

“While Wachovia may have had reason to question [Dreier’s] honesty ... this does not add up to actual or constructive knowledge” that he was running a Ponzi scheme or that loan proceeds were being used in the scheme. The court therefore dismissed the bulk of the trustee’s claims with prejudice.

Judge Bernstein granted the trustee leave to replead an “escrow transfer theory” of liability. If loan proceeds were transferred into the Ponzi scheme account at Chase, and the trustee can demonstrate that the account was a true escrow account, the deposit might be a fraudulent transfer of the law firm’s equitable interest in the loan, he said.

“Wachovia may have been guilty of bad banking, but the complaint fails to allege that it had actual or constructive knowledge of [Dreier’s] fraudulent scheme,” the judge wrote.

Dreier started his Ponzi scheme in 2004, selling fake notes to hedge funds in the name of a New York real estate development company.

The $400 million scheme unraveled four years later when Dreier was arrested in Canada for impersonating another client in an effort to raise additional money to conceal the scheme.

Dreier LLP subsequently was forced into bankruptcy, and Gowan was appointed as its Chapter 11 trustee.

Dreier himself later became the subject of an involuntary Chapter 7 bankruptcy proceeding. He is serving a 20-year prison sentence after pleading guilty in May 2009 to charges of securities fraud, money laundering, wire fraud and conspiracy.

According to Judge Bernstein’s opinion, Wachovia, which since has been acquired by Wells Fargo Bank, made a series of pre-bankruptcy loans and extended credit to Dreier LLP in exchange for security interests in the firm’s property.

After the bankruptcy cases were filed, Wachovia was reimbursed more than $16 million from a Dreier LLP money market account that secured its letters of credit, the opinion said. The trustee also paid Wachovia nearly $4 million under a cash collateral order entered by the Bankruptcy Court that reserved the trustee’s right to seek avoidance of Wachovia’s asserted liens and disgorgement of post-petition payments.

Gowan subsequently filed a 26-count complaint against Wachovia last December. She alleged the bank so wanted to keep Dreier’s business that it disregarded concerns from several employees that he and his law firm had insufficient cash flow, and that Dreier had used firm funds to purchase a yacht for himself, was late on loan repayments, and had made misrepresentations on his financial statements.

The trustee eventually withdrew most of the claims but continued to allege that the various Wachovia obligations and related liens were constructively fraudulent, intentionally fraudulent or preferential.

The bank responded with a motion to dismiss, saying the allegations in the complaint amount to nothing more than a series of unexceptionable banking transactions.

Judge Bernstein granted the defense motion.

The complaint failed, however, to allege sufficiently that Wachovia was aware of the scheme.

“Their theory does not depend on Wachovia’s knowledge of a Ponzi scheme,” the judge said.

**Attorneys:**
- **Plaintiff (Trustee):** Howard D. Ressler, Diamond McCarthy LLP, New York
- **Defendants:** Jordan W. Siev, Reed Smith LLP, New York

**Related Court Document:**
- Opinion: 2011 WL 3319711

Scan this code with your QR reader to see the opinion on Westlaw:
MOTORCYCLIST’S ESTATE SAYS LAWYERS BOTCHED SUIT

The estate of a motorcyclist killed in a collision with a drunken driver alleges in Virginia state court that two attorneys failed to prepare a wrongful-death case for trial and then botched a second lawsuit, precluding the estate from pursuing the action. Chermarca Reed, on behalf of the estate of Jerry Damon Taybron, says attorneys Duncan Brent and Jeffrey Raden failed to contact necessary witnesses and answer discovery requests, forcing them to take a nonsuit. The attorneys refiled the case, Reed’s complaint says, but never served the defendant, so the suit was dismissed with prejudice. Reed alleges the lawyers breached their contract and duty of care and committed fraud by concealing their missteps. The malpractice complaint requests $3 million in compensatory damages and $350,000 in punitive damages.

Reed v. Law Offices of Jeffrey D. Raden LLC et al., No. 11-2010, complaint filed (Va. Cir. Ct., Arlington County Aug. 29, 2011).

Related Court Document: Complaint: 2011 WL 3922613

FIRED ASSOCIATE SUES LAW FIRM FOR $77 MILLION

A first-year lawyer who says he was fired by a New York law firm after he told partners he deserved more responsibility because of his “superior legal mind” is suing the firm for $77 million. Gregory Berry’s state court suit alleges that Kasowitz, Benson, Torres & Friedman told him before hiring him that it valued creativity and intelligence but then fired him for exhibiting those very traits. Berry, who claims he did “superlative work” during his eight months at Kasowitz, says a partner told him he had “burned bridges” by asking for additional responsibility, and he was fired a few days later. Berry’s claims include fraudulent misrepresentation, wrongful termination and infliction of emotional distress. He seeks $27 million in compensatory damages and $50 million in punitive damages.


Related Court Document: Complaint: 2011 WL 3572002

IOWA SUPREME COURT REJECTS DISCIPLINARY CHANGE

Iowa’s attorney disciplinary rule that requires public disclosure of the reasons for a law license suspension will stay intact, the state’s Supreme Court announced Aug. 26. The high court rejected a proposal by the state office responsible for processing disciplinary complaints to allow the reasons for a suspension to remain confidential if the lawyer consents to a voluntary suspension. The Office of Professional Regulation had suggested the proposal as a way to make the attorney disciplinary process more effective by reducing delays, according to the court’s statement. Public disclosure of the reasons for a lawyer’s suspension is necessary, the court said, because the lawyer might practice law again once the suspension is over. “In this situation, the interest of the public in having information about the attorney’s misconduct outweighs the need to expedite ethics prosecutions,” the court’s statement says.
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