

SECURITIES FRAUD MONITOR

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B E R M A N D E V A L E R I O P E A S E T A B A C C O B U R T & P U C I L L O

INTERVIEW

Institutional Investors Leave Money on the Table

Vanderbilt University Law School Professor Randall S. Thomas made waves in the public fund community three years ago with the paper, *Leaving Money on the Table: Do Institutional Investors Fail To File Claims in Securities Class Actions?*

The study found that institutional investors were letting billions of dollars



Randall Thomas

slip through their fingers, failing to submit claims forms in the majority of securities class action settlements.

A larger follow-up report now nearing

publication has drawn a similar conclusion: during the study period, financial institutions with significant, provable stock losses neglected to file claims an astounding 70% of the time. According to Thomas and co-author Professor James D. Cox of Duke University, institutions are missing out on average median recoveries of more than \$90,000 per settlement.

The *Securities Fraud Monitor* recently spoke with Thomas about his findings and about what institutional investors should do to collect their fair share of settlement dollars. We hope our readers will find his insights both interesting and useful.

SECURITIES FRAUD MONITOR: What's the first order of business for pension funds trying to determine whether settlement dollars are slipping away from them?

RANDALL THOMAS: I think a lot of pension funds already are doing what they should be doing. They have set up systems for insuring that they file claims in securities fraud class action settlements. But the principal thing I suggest is that all funds monitor their systems. They should track how their internal processes work or what their custodians have done to file claims over a certain period of time. Then they should compare these to where they

think they should be in terms of dollars collected.

It's very important for trustees to think about whatever systems they have in place and to consider whether they are working effectively. If they are not functioning effectively, then they need to redesign their systems.

SFM: What do funds typically find when they do this self-monitoring?

RT: It varies tremendously, so I can't make an across-the-board statement. Some custodians have become very sophisticated about their claims filing system and do a very good job. Things

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Money Makes Their World Go Round

The rich just keep getting richer. Or at least the CEOs do.

Chief executive bonuses jumped nearly 50% last year to a median of \$1.14 million. That's the biggest percentage gain and highest level in at least five years, according to a Mercer Human Resource Consulting survey conducted for *The Wall Street Journal*.

The study found that the median direct CEO compensation was \$4,419,300, or about 160 times the earnings of the average American production worker. Moreover, the

median bonus for 2004 was equal to a record 141% of annual salary. A separate study – this one for *The New York Times* – found that chief executives at 179 large companies earned an average of \$9.84 million, 12 percent more than in 2003.

But even these averages may be significantly understated, since public firms are not required to disclose the values of executive pension plans. According to a new study of S&P 500 CEOs by Harvard Professors Lucian

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Rich CEOs

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Bebchuk and Robert Jackson, executives' pension plans had a median actuarial value of \$15 million.

Chief executives aren't just earning record amounts. Many are also raking in the bucks while their companies are struggling. Take Hewlett-Packard's ousted Carleton S. Fiorina. She banked \$42 million after Hewlett-Packard's board forced her out of the top spot

because of poor financial results.

Fiorina is not alone. Blockbuster CEO John Antioco earned \$51.6 million in direct compensation last year, while the company lost \$1.25 billion. Raymond V. Gilmartin of Merck pocketed a \$1.38 million bonus in the same year the drug maker had to pull Vioxx off shelves.

Adding insult to shareholder injury, companies rarely – if ever – ask the CEOs to return their bonuses when financials are restated. Look at William A. Wise, the chief executive of El Paso Corp who was handsomely compensated when the energy company reported a \$93 million profit for 2001.

In addition to his salary of \$1.3 million, Wise reaped a cool \$3.4 million bonus, 768,250 stock options, \$1.7 million of restricted stock and \$3.7 million in "other compensation."

Turns out, though, the earnings were fictitious. Last year, the energy company disclosed a loss of \$447 million in 2001. Although Wise was pushed out in 2003, he held on to his bonus.

(Ed. note: Berman DeValerio is co-lead counsel in a securities fraud case against El Paso, representing the Oklahoma Firefighters Pension and Retirement System.)

Not surprisingly, El Paso has not tried to recover any of the payments to Wise. Most companies in similar situations display comparable lethargy.

"Directors seem reluctant to pursue bonus payments after a restatement because they desperately want to avoid a public flap or the appearance of wrongdoing by the company," said Michael Lange, a Berman DeValerio partner. "Either way, shareholders lose."

If boards and shareholders are relying on regulators to step in and recoup executive pay, they may be out of luck. Although the Sarbanes-Oxley Act of 2002 includes a bonus payback

provision when financials later prove false, the Securities and Exchange Commission has yet to exercise its authority in the matter.

"Corporate mega scandals and new regulatory requirements have stretched the SEC pretty thin," Lange said. "That means, more than ever, it's up to the boards to take the lead."

Still, shareholders shouldn't hold their breath. In many cases, the boards of directors are reaping big rewards of their own.

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Yet another recent study evaluated stock options granted to CEOs from 1992 to 2002. The study focused on the increasingly common practice of what the authors call "timing opportunism" – that is, the granting of stock options just before good or just after bad company news.

Baruch College Professors Donal Byard and Ying Li found that the likelihood of timing opportunism increased when board members themselves received large proportions of stock options as part of their pay packages.

All of this means that even supposedly independent directors may be more aligned with top management than they are with investors.

"Boards need to remember their duty to uphold shareholder interests, not to pad their own pockets and line those of rich CEOs," said Lange. "Most people wouldn't give their waiter a generous tip if the service was awful. Neither should the boards." ■

BERMAN DEVALERIO PEASE TABACCO BURT & PUCILLO

Berman DeValerio Pease Tabacco Burt & Pucillo prosecutes class actions nationwide on behalf of institutions and individuals, chiefly victims of securities fraud and antitrust law violations. The firm, which was founded in 1982, has offices in Boston, San Francisco and West Palm Beach. In addition to conducting litigation, the firm provides securities fraud monitoring, evaluation and advisory services to public pension funds and other institutional investors.

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Money on the Table

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have improved tremendously since we wrote our first paper. Moreover, it's important to view our paper and data in context. We are reporting on a sample of settlements from the late 1990s and into early 2001.

SFM: Are you saying, then, that a lot has changed in the claims filing arena?

RT: When we published our first paper in 2002, people were much more naïve about how this worked. In the past three to four years, third-party service providers and law firms have done a pretty good job of making trustees aware of their fiduciary duty to file claims. My sense is there is now a much greater amount of awareness of the issue among trustees.

SFM: Are there ways for you to determine if funds today are filing all the claims they should?

RT: Our ability to crosscheck data for claims filing is limited to the data we can obtain from claims administrators. I understand that the SEC is now doing an informal inquiry asking funds for information about claims filing practices. So that may generate some new data.

SFM: In your paper, you propose that the SEC should make its filing methodology more accessible, and recommend making that system easier to use. Given the SEC's tight budget and the current political climate, how realistic is it to expect that the government will step in?

RT: That recommendation is the only one that requires any resource allocation by the SEC. What we are really asking the SEC to do is to make the database easier to query – to make it more transparent. So, for example, institutional investors who want to confirm that their holdings are accurately represented can actually do so. We're not talking about a major enforcement effort and we're not suggesting that the SEC devote enormous resources or create a new department.

But if the SEC is going to encourage better filing, it should occasionally check up to make sure funds are doing so. Simply saying that funds should file claims and then never checking if they do is not very effective.

In the past three to four years, third-party service providers and law firms have done a pretty good job of making trustees aware of their fiduciary duty to file claims.

SFM: What else do you suggest to improve the compensatory process?

RT: Our principal recommendation is directed to the courts. The main thing that would make a big difference here is for the courts to create an informational clearinghouse, so investors can see what cases are settling. Courts have tremendous power in approving settlements and could easily require posting of this information to a centralized Website database.

An academic or private institution could host the site, particularly if the court promised some nominal fee. For example, Stanford has an excellent

Website that could be the basis for something like this.

SFM: Do you think that would be a more effective mechanism than using third parties or law firms?

RT: Not to knock anything that you guys are doing, because I think it's great, but the big problem is that these services are not available to everybody. What you need is something that anyone can log into, that would be available for individuals, too. If a small fraction of each settlement were devoted to supporting a Website like that, there would be a significant benefit.

The other key recommendation we make is to establish a standardized set of claims forms, so every time you file, you don't have to come up with new kinds of documentation. The current system sometimes makes it impossible for funds to file because they don't have the right documentation. A standardized form would reduce costs by letting institutions know what information they will need for every claim they file.

SFM: If more claims are filed, won't the practical effect be that each institution ultimately gets a smaller piece of the settlement pie?

RT: Probably for the immediate present, but I think if institutions and other individuals were filing claims 80 to 90 percent of the time, then there would be increased pressure on both the plaintiffs' lawyers and on the companies to raise the overall settlement amounts.

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Money on the Table

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SFM: Do you think there is a better way to determine losses and settlement amounts?

RT: We are now working on a paper that attempts to come up with a model that is more reasonable than those used by the plaintiffs' and defendants' bars. I can't claim that it is the perfect model, since there are a lot of judgment calls as far as what constitutes losses and how much is attributable to other factors. I'm not sure there will ever be a judicially accepted standard.

Courts have tremendous power in approving settlements and could easily require posting of this information to a centralized Website database.

SFM: How much impact have cases like Enron and WorldCom had on settlements?

RT: Certainly the size of settlements has shot up in the last four years. The WorldCom settlement is now above \$6 billion. When you start talking about that kind of money, people start paying a lot more attention to what they're getting back.

I think that the corporate governance scandals of the late bubble period shifted people more in favor of securities fraud class actions. For better or worse, however, there's been a shift back in the other direction after the last election. Based on the changing political climate, I predict you will see less public enforcement sooner rather than later. ■

How Much Is Out There?

Investors are due to recoup billions of dollars of investment losses from recent securities litigation settlements, according to Securities Class Action Services, a subsidiary of Institutional Shareholder Services.

SCAS, which maintains a database on securities cases, has identified an \$8.7 billion pipeline of pending and tentative settlements from which investors are entitled to collect recoveries. In 2004 alone, securities settlements approached \$6 billion.

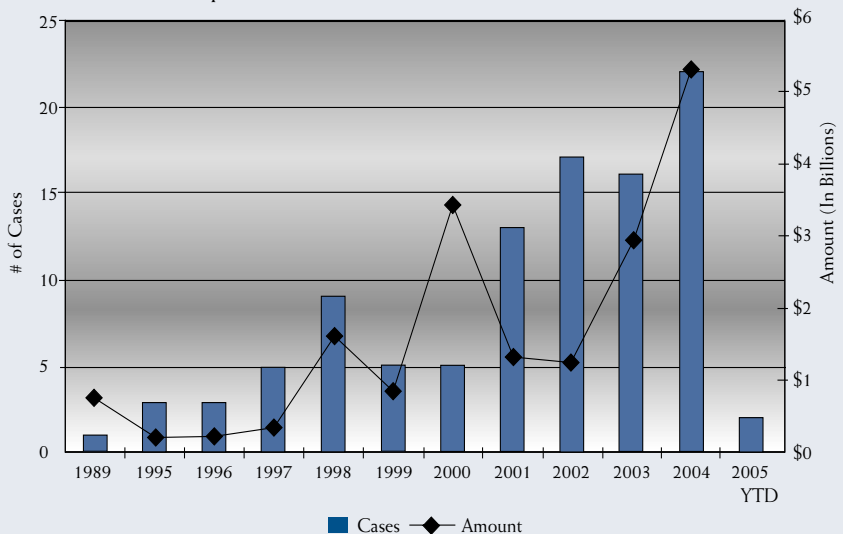
It's not hard to see where the billions are coming from. Earlier this year, SCAS released a report on the all-time top 100 securities class action settlements. The list is restricted to final settlements where courts have granted approval.

The top five settlements are: WorldCom (now \$6 billion); Cendant (\$3.2 billion); NASDAQ Market-Makers (\$1 billion); Washington Public Power (\$757 million); and Lucent Technologies (\$517 million). Preliminary agreements in the McKesson HBOC litigation (\$960 million) and multiple Enron settlements (over \$500 million) are not included.

The report also breaks down settlements by plaintiffs' firms. Berman DeValerio ranks as one of the top firms, with eight of the top settlements. Only two others served as lead or co-lead counsel in more settled cases.

In a separate SCAS rating of recoveries for 50 securities litigation firms, Berman DeValerio placed fifth among its peers in 2004, having acted as lead or co-lead counsel in 10 class action settlements worth \$578,550,000. Berman DeValerio's average settlement size for the year, \$57,855,000, ranked it fourth among the 50 firms. ■

Top 100 Securities Class Action Settlements



Corporate America's Bully Tactics Gain Ground

By Glen DeValerio

The recent conviction of WorldCom's Bernard Ebbers certainly constituted a victory in the war against corporate crime. At first glance, the guilty verdicts also seem to reflect some momentum in efforts to bring wrong-doers to justice.

Not so. Despite misdeeds that have wrung hundreds of billions of dollars out of the stock market, despite myriad guilty pleas and a mounting number of convictions, Corporate America is crying foul, brazenly stepping forward to complain that the pendulum has swung too far. And the tactic is working.

Though it is almost impossible to believe, the same folks who brought us the cataclysmic meltdowns of once-storied corporations are now whining that the resulting regulations are too stringent. Amazingly, in this era of unprecedented corporate fraud, the business lobby claims it needs relief.

Sounds a bit like the playground bully who cries when the other kids finally put him in his place.

The U.S. Chamber of Commerce and its allies have launched a carefully choreographed, multi-pronged attack on regulators, prosecutors, public pension funds, trial lawyers and the Sarbanes-Oxley Act created by Congress to curb fraud.

On June 2, 2005 President Bush nominated California Republican Representative Christopher Cox to replace resigning SEC Chairman William Donaldson. This will cause an unwelcome sea change at the agency, removing a strong regulator in favor of a champion of de-regulation and vocal opponent of private rights of action

against corporate wrong-doers.

Apparently, it doesn't matter that corporate financial restatements (often a harbinger of fraud) reached an all-time high of 414 last year. Nor, evidently, does it matter that fraud cases continue to dominate business page headlines (think AIG and Fannie Mae, for example).

More than three years after the Enron scandal broke, there's little indication that Wall Street has cleaned up its act. As the 2004 restatement figures demonstrate, companies continue to toy with their financials, at investor expense.

The Chamber is quick to blame corporate misdeeds on a few bad apples, conveniently neglecting the overarching culture that has allowed fraud to fester. The business lobby is manipulating the facts and ignoring reality, promulgating the idea that corporations are the ones that are suffering. Try explaining that to investors still reeling from their stock market losses since 2001.

Business interest groups are now hard at work in their well-funded campaign to soften federal securities laws (see our sidebar on page 6). The pro-business folks have also pressured the Securities and Exchange Commission to reject the proposed shareholder access rule that would give investors more say in who runs the companies they own.

Also in the crosshairs of the business coalition: state attorneys general and federal prosecutors who try the wrongdoers; and plaintiffs' attorneys who recover billions for injured investors through securities class

actions. The Chamber's Institute for Legal Reform complains that corporations spent \$3 billion in 2003 to settle securities fraud cases and another \$3 billion on legal costs – an increase of about 40 percent from several years earlier.

Yet it only stands to reason that corporations would spend more to clean up their own mess. The frauds at Enron, WorldCom, Bristol-Myers Squibb, HealthSouth, Sunbeam and countless others have pushed the corporate legal tab up, not enterprising lawyers. Businesses are paying more in legal fees because the frauds are bigger – and more commonplace.

According to the consulting group NERA, larger settlements can be explained in part by higher investor losses. The average investor losses jumped to \$2.5 billion in 2003 from \$140 million in the typical suit settled in 1996.

For years we in the plaintiffs' bar were attacked because we weren't recovering enough money for swindled investors. Now we're attacked because we're recovering substantially more.

The U.S. Chamber should stop blaming the messenger and start focusing on the obvious truth: corporate America has been engaged in an unprecedented number of serious securities frauds that have significantly harmed our economy, our retirements and our investments.

The pendulum has not swung too far. It has merely returned to the center after an era of corruption enabled by the absence of regulation. How soon we forget. ■

Battle Heats Up in Section 404 Debate

A controversial section of the Sarbanes-Oxley Act aimed at making publicly traded companies maintain adequate accounting procedures may be dying a slow death despite evidence that it is sorely needed.

Section 404, as the provision is known, forces companies to evaluate (and accounting firms to corroborate) the internal controls used to ensure accurate financial reporting.

Businesses and their lobbying groups have been vociferously complaining that Section 404 costs too much, particularly for small- and medium-sized companies. They are pushing the Securities and Exchange Commission to soften the requirements.

Sarbanes-Oxley and Section 404 were designed as a clear-headed response to the major corporate frauds that roiled Wall Street.

The SEC is listening. On April 13, the agency held a daylong roundtable discussion, hearing testimony from groups on both sides of the debate.

In the weeks leading up to the symposium, the now outgoing SEC chairman, William Donaldson, seemed committed to maintaining Section 404, calling a rollback "short-sighted" and describing the rule and its associated costs as "money well spent."

But after the roundtable, Donaldson seemed to be changing his tune.

"I would be very disappointed if we didn't find some things we could do," he told reporters. "The American people have been saying (404) is a very

good idea, but it costs too much. We have to be attentive to that."

Already, the SEC has encouraged auditors to use discretion to trim the checks they must perform. And the Public Company Accounting Oversight Board released a new policy statement that will likely reduce 404 costs for companies.

Sarbanes-Oxley and Section 404 were designed as a clear-headed response to the major corporate frauds that roiled Wall Street. And while they may be expensive, they are needed.

According to Donaldson, some 2,500 companies had filed internal control reports with the SEC by the end of March. About 200 of those reports, or 8%, uncovered material weaknesses. One accounting firm found 63,000 control deficiencies among the 225 registrants it audits, Donaldson said. That's an average of 275 deficiencies per company.

In a *Wall Street Journal* review of some 50 public filings, the reported weaknesses ranged from minor, easily correctable issues to more significant

problems that could potentially result in restatements.

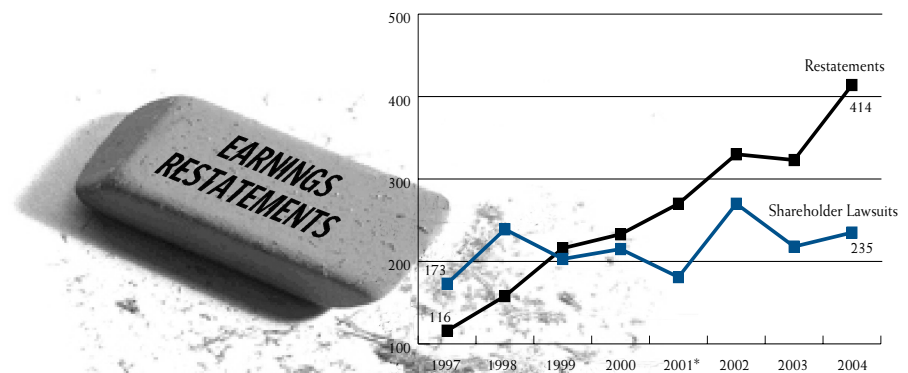
A Dow Jones Newswire survey indicated that problems discovered in the 404 inspections may have resulted in dozens of earnings restatements, including those at Chiron Corp. and ConAgra Foods Inc.

But for businesses, Section 404 is all about the money. According to Financial Executives International, which represents chief financial officers and treasurers, Section 404 cost companies an average of \$4.3 million last year. Expensive? Yes. Worth it? Absolutely.

Of course, costs may have been high because it was the first year of implementation, a fact noted by many of the act's proponents, including the Ohio Retirement Systems. In a letter to the SEC, ORS executive directors urged the SEC to protect Sarbanes-Oxley and Section 404.

Section 404 may not be perfect. But watering it down sends the wrong message at a time when corporate scandals still make headlines. ■

Securities Class Actions and Corporate Restatements



*Does not include IPO allocation suits

SOURCE: Stanford University Law School and Huron Consulting Group