Winter 2005

SECURITIES FRAUD MONITOR

BERMAN DEVALERIO PEASE TABACCO BURT & PUCILLO

INTERVIEW

Reformers Fall Short on Executive Compensation

Lucian Bebchuk

Lucian Bebchuk, Professor of Law, Economics, and Finance and Director of the Corporate Governance Program at Harvard Law School, has been a central figure in debates on corporate reforms.

In a recently published book, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press), Bebchuk and co-author Jesse Fried strongly critique the practices companies now use to determine executive compensation and propose improvements.

Vanguard Group founder John C. Bogle called it "a book that must be read ... by any citizen who cares about our society." In an interview with the *Securities Fraud Monitor*, Bebchuk discussed the book, his recent empirical work on corporate governance, and his ideas for reform.

SECURITIES FRAUD MONITOR: How important is the subject of executive compensation to the economy? What is at stake?

LUCIAN BEBCHUK: The problems of executive pay have practical significance for investors and the economy. The amounts involved are substantial, even relative to the large market capitalization of public firms. In a recent empirical study with Yaniv Grinstein, we found that public firms paid their top five executives an aggregate compensation of about $250 billion during the decade 1993-2002. Furthermore, aggregate compensation for the top five executives equaled 10% of aggregate corporate earnings in 1998-2002, up from 6% of aggregate corporate earnings during 1993-1997. Thus, if we could cut compensation without weakening managerial incentives, which we show in the book to be possible, the effect on shareholders' bottom line would be significant.

Moreover, executives' excess pay is not the only cost — probably not even the main one. Current pay arrangements provide diluted and sometimes perverse incentives. Eliminating such distortions could produce substantial benefits.

SFM: How much is an executive's pay linked to his or her performance?

LB: Pay is far less sensitive to performance than is commonly recognized. To begin, there is evidence that cash compensation, including the large amounts paid in bonuses, correlates little with managers' own performance. In addition, executives receive a lot of value through what we call "stealth compensation" – forms of pay whose dollar amount is not included in publicly filed compensation tables. This stealth compensation also isn't tightly linked to performance.

Even with respect to equity-based pay, the link between pay and performance is much weaker than it could be. Most of the payoffs from executives' equity-based compensation do not depend on managers' long-term performance but come from market-wide and industry-wide movements, as well as from short-term fluctuations in stock prices.

Furthermore, compensation contracts and provisions provide executives with substantial downside protection that further weakens the link between pay and performance. Compared with other employees, executives receive an unusually large portion of their full-term compensation if they leave due to poor performance.

Finally, current compensation arrangements not only fail to provide incentives to enhance shareholder value in a cost-effective way, but also provide perverse incentives. For example, broad freedom to unload options and shares has given executives incentives to produce short-term stock price increases instead of long-term value.

Continued on page 10

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.

The *Securities Fraud Monitor* is published quarterly by the law firm of Berman DeValerio Pease Tabacco Burt & Pucillo, One Liberty Square, Boston, MA 02109, (800) 516-9926. This newsletter is designed to inform Berman DeValerio's clients and friends about current securities fraud and corporate governance issues. It is not a substitute for legal advice.

If you would like to receive additional copies of this issue, or if you would like to be added to our mailing list for future issues, please contact Richard Lorant, Director of Marketing & Communications, at (617) 646-1825 or rlorant@bermanesq.com.

Peter A. Pease, *Executive Editor*
Richard Lorant, *Managing Editor*

Copyright 2005
Berman DeValerio Pease Tabacco
Burt & Pucillo
www.bermanesq.com

EDITORIAL

Privatizing Social Security Will Do More Harm Than Good

President Bush appears determined to replace Social Security with personal savings accounts. In the president's world, the so-called "ownership society" is all about empowering individuals while simultaneously fixing a looming Social Security cash crunch.

What his plan is really about, however, is completing a massive shift of the investment risk associated with retirement from corporations, taxpayers and public employers to the nation's employees themselves. That's a huge mistake.

We already know that the country has a dismal personal savings rate – at 0.2%, it's the second-lowest level on record. Such a disheartening statistic makes it all but impossible to believe that the average American will have the discipline to save enough to fund his own retirement.

Social Security critics see the system as paternalistic. After all, their argument goes, shouldn't individuals be responsible for their own future? Sure they should, if we were living in an ideal world. But the reality is that too many individuals will ignore all the practical savings advice, finding a leased car or a home entertainment system – or food for their kids – far more tantalizing than a savings account for old age.

If we eliminate Social Security, we could end up a nation of elderly poor. Unless we're willing to tolerate that – and let's hope we are not – then taxpayers and society will be forced to bear the costs in other ways.

The irony is this: President Franklin D. Roosevelt launched Social Security in the 1930s to aid the enormous number of elderly impoverished by the Great Depression. Ending the system could simply create new generations of impoverished senior citizens.

A radical overhaul of Social Security may prove to be Bush's top domestic agenda item as he begins the first year

Continued on page 9

— Our Partners —

Boston • Phone: (617) 542-8300

Norman Berman, nberman@bermanesq.com
Glen DeValerio, gdevalerio@bermanesq.com
Peter A. Pease, ppease@bermanesq.com
Jeffrey C. Block, jblock@bermanesq.com
Kathleen M. Donovan-Maher, kdonovan-maher@bermanesq.com
Michael G. Lange, mlange@bermanesq.com
Leslie R. Stern, lstern@bermanesq.com

San Francisco • Phone: (415) 433-3200

Joseph J. Tabacco, Jr., jtabacco@bermanesq.com
Christopher T. Heffelfinger, cheffelfinger@bermanesq.com
Nicole Lavallee, nlavallee@bermanesq.com

West Palm Beach • Phone: (561) 835-9400

C. Oliver Burt, III, cburt@bermanesq.com
Michael J. Pucillo, mpucillo@bermanesq.com
Wendy H. Zoberman, wzoberman@bermanesq.com
R. Scott Palmer, rspalmer@bermanesq.com

'Efficient Market' Debate Slows Class Actions

By Peter A. Pease

Until recently, a court order certifying the class in a shareholder lawsuit was nearly a foregone conclusion, so long as the proposed class representatives and their counsel were properly attentive. No more.

Using an esoteric academic debate over whether or not the securities markets are "efficient," defense attorneys have set their sights on defeating class certification. If they succeed, the ramifications will be enormous. Without a class, there is no class action – and the threat of liability for securities fraud is substantially diminished.

These new class certification challenges are framed as assaults on the underpinning of the fraud-on-the-market theory. That theory – adopted by the Supreme Court in *Basic v. Levinson* – allows investors to presume the reliance of all stock purchasers upon the integrity of its market price, so long as that market is "efficient."

It is a critical presumption. Without it, it would no longer suffice for a plaintiff class representative to prove that a company made fraudulent public statements that affected its stock price. Every single class member alleging fraud would have to prove individually that he knew about the fraudulent statement and relied on it when he bought his shares.

Even if every class member could prove this separately, the case would not be allowed to go forward as a class action. Because of the individual proof required, the court would deny certification and require each stock purchaser to file his or her own separate case. Since economic factors preclude this, defendants would escape liability almost entirely.

Far from the Supreme Court, economists have been holding their own debate over whether the securities markets are efficient. The academics, covering terrain broader than the jurists, are arguing over whether the market price of a stock fully, rapidly and accurately reflects all publicly available information about the company.

Economists have been quarrelling over this so-called "efficient market hypothesis" for years, and the Internet bubble caused their long-simmering feud to boil over. Some economists argue that irrational investors in the heady days of Internet IPOs created an overvalued and therefore inefficient market for many dot-com and technology stocks.

Emboldened by the high stakes, defense lawyers have seized upon the academic dispute and dragged it into the courthouse, arguing that markets were inefficient during the class periods in question – particularly for companies issuing stock during the bull market that began in the late 1990s.

Take, for example, the recent securities case against PolyMedica Corp., in which defendants argued that the market for PolyMedica's stock was

Continued on page 6

Supreme Court Case Has Huge Implications For Securities Class Actions

The general public has barely noticed the United States Supreme Court case involving Dura Pharmaceuticals. They ought to pay closer attention. The court's eventual ruling could have enormous implications for investors.

If the court sides with Dura, shareholders will have a much tougher time suing securities fraud violators and recovering meaningful settlements.

At issue is how losses are calculated after a company's stock drops due to accounting or other shams. The question awaiting the justices in *Dura Pharmaceuticals Inc. v. Broudo:* must a securities fraud plaintiff plead that a stock price dropped after a "corrective disclosure" in order to show loss causation. Examples of corrective disclosures include earnings restatements, newspaper exposes and announcements of regulatory investigations.

By taking the case, the Supreme Court may be trying to clarify pleading requirements that have differed greatly from one federal circuit to the next. In the 8th and 9th Circuits, for example, plaintiffs can plead loss causation by alleging that a company's share price was inflated at the time of purchase. Other circuit courts, including the 2nd, 3rd, 7th and 11th, have required that plaintiffs allege a corrective disclosure

Continued on page 7

Before You Go, Chairman Donaldson…

Word is that SEC Chairman William Donaldson may not be long for his position. Donaldson is widely expected to retire in the next year or two – maybe sooner. That would be a pity.

As we begin another four years of a pro-business-at-all-costs Bush Administration, it is more important than ever for Donaldson to remain at the helm of the regulatory agency until his term expires in June 2007. Although appointed by Bush, Donaldson has proven to be a zealous advocate for investors.

When he took over in 2003, many assumed the former investment banker would be a cozy cousin of the corporate world. In fact, he has frequently sided with the two Democrats on the commission and has advanced a decidedly pro-investor agenda.

Bush can't be pleased with Donaldson's track record of heightened regulation. In one of last fall's presidential debates, Bush confessed that he "made some mistakes in appointing people." He didn't name names, but some – including *The Wall Street Journal* – have speculated the President had Donaldson in mind.

By now Donaldson should be accustomed to the steady attacks emanating from the business lobby, conservative lawmakers, and the *Journal's* editorial pages, to name a few. To these groups, Donaldson's SEC has been too activist in its attempts to regulate corporate America.

But Wall Street needs vigilant regulators, as headline-making scandals continue to demonstrate. More work – and a lot of it – still must be done to clean up the boardroom. We hope Donaldson sticks around long enough to continue to give shareholders a much-needed boost.

In the spirit of the holidays just past, here is our wish list of items we'd like to see Donaldson push through before he steps down.

The Proxy Rule Change

If Donaldson accomplishes just one more thing, it should be this: approval of the stalled plan allowing major investors to nominate alternative members to the boards of publicly traded companies. The rule doesn't appear to be any closer to approval than when we wrote about it in our Fall 2004 newsletter. Proposed well over a year ago as a means of empowering shareholders, the measure quickly met with resistance from pro-business groups.

If Donaldson accomplishes just one more thing, it should be this: approval of the stalled plan allowing major investors to nominate alternative members to the boards of publicly traded companies.

By all accounts, the proxy access rule continues to be at an impasse, with two commissioners in favor, two opposed, and Donaldson seeking the middle ground.

"My hope is that some sort of compromise will be possible," the *Financial Times* quoted Donaldson as saying late last year. "It is not number one on my agenda."

We think it should be. While far from perfect, the proposal gives shareholders a much-needed avenue to the boardroom. The measure is too vital to allow it to die at the hands of the corporate lobby.

Mutual Fund Reforms

More than a year after New York Attorney General Eliot Spitzer went after the mutual fund industry for late trading and market timing, the SEC still has regulatory changes waiting in the wings. Among them, a contentious plan to eliminate late trading by establishing a so-called "hard" market close. The proposal would require all buy and sell orders to be made before 4 p.m. Eastern Time.

Critics have complained that such a deadline will make it significantly harder for investors to place orders with brokers and other intermediaries. Moreover, they argue, investors on the West Coast will have a particularly difficult time getting in at the day's price.

We appreciate the logistical difficulties and the pressures the SEC must be under to forge a compromise. However, the agency must find a way to eliminate the problem and create a level playing field for all mutual fund investors.

Similar thorny issues have surfaced in the attempt to crack down on market timing, the rapid in-and-out trading of funds. While not specifically prohibited by law, the practice has been barred by most fund firms, largely because it inflates costs for everyone.

To combat the problem, the SEC is weighing a 2% redemption fee on shares sold within five days. Opponents say this would create unnecessary costs for traders and for plan administrators. Here again, we call on the SEC to find a solution based on fairness. We recognize the difficulties in changing

Continued on next page

the rules, but it's time for the SEC to respond.

Independent Fund Chairmen

To the dismay of many mutual fund firms, the SEC voted 3-to-2 last summer to require that 75 percent of a fund's board and its chairman be independent of fund management. Now that rule is the subject of a lawsuit filed by the U.S. Chamber of Commerce.

The requirement also now faces legislative fire. Congress passed a bill late last year forcing the SEC to justify the independent fund chair rule. As written in the bill, the SEC must study whether funds with independent chairs "perform better, have lower expenses, or have better compliance records than mutual funds chaired by interested directors."

The report, due to Congress by May, is drawing some heavyweight bipartisan criticism.

Ohio Republican Michael Oxley, the chairman of the House Committee on Financial Services, and Democrat Barney Frank (D-Mass.) sent a letter to Donaldson in support of the independent fund chairman requirement.

"Given the unprecedented number of enforcement and rulemaking activities the Commission is undertaking in response to the Sarbanes-Oxley Act, mutual fund scandals, and other developments in the financial services markets, we believe it is imprudent to require the SEC to allocate its resources for a study of whether the well-considered and long-debated rulemaking is justified," the lawmakers wrote. "What is more troubling, however, are the active lobbying efforts by some in the fund industry to overturn a rulemaking by an independent agency before it even takes effect."

We agree with the two Congressmen. We hope Donaldson and the SEC are able to stand up to the pressures of the business lobby. The independent chairman rule change sends a strong message to Wall Street.

Happier Times? President Bush announcing his selection of William Donaldson as chairman of the SEC.

The Fines Debate

Donaldson is facing increasing pressure from the two Republican commissioners on the subject of fines. Over the last two years, the SEC has been issuing increasingly large financial penalties on wayward companies.

Donaldson and others say the fines are a deterrent to bad behavior. Critics, however, say the fines just punish shareholders all over again by further eroding the stock's value.

According to *The Wall Street Journal*, SEC-imposed penalties have been growing substantially over the last few years. Overall penalties jumped 17 percent to $2.68 billion in fiscal year 2004, up from $2.29 billion in 2003. In FY2002, penalties totaled just $1.39 billion. The Sarbanes-Oxley reform bill allowed the SEC to levy fines as a way to compensate wronged investors.

We believe fines are important weapons in the enforcement arsenal – along with criminal and civil prosecution, legislative reform and, of course, litigation.

Executive Pay Disclosure

Donaldson has been openly critical of the pay and compensation packages lavished on corporate executives. He has been equally critical of the oblique way the compensation is disclosed to investors.

"I believe in people being well paid for really doing something," Donaldson told the *Washington Post*. "(But) as far as salaries and compensation are concerned, there remains obfuscation about who's being paid what …. We have to think through what new rules we want to make things more clear than they are now."

It's a safe bet that the business lobby will oppose any new rules governing pay disclosure. Donaldson would do well to promote rule changes that make executive paychecks and perks more transparent for investors. ■

Challenges

Continued from page 3

not efficient during the first eight months of 2001.

Ultimately, U.S. District Judge Robert E. Keeton ruled for the plaintiffs, certifying the class in September 2004. "When legal precedent is available, I follow it, not economic or academic literature," the judge wrote. But the fight added another hurdle for investors and slowed progression of the case.

If the courts tell plaintiffs' attorneys that we can't litigate these cases as class actions, then defendants will only have to worry about how many individuals can file claims against them.

In another securities case against Xcelera, an Internet holding company, defendants made a similar argument that the market was irrational and inefficient. Defendants tried to show that Xcelera stock was wildly overvalued in relation to earnings and no reasonable investor could rely on the integrity of the stock price. The defendants succeeded in raising the court's interest to the point that an evidentiary hearing was scheduled and competing expert witnesses were examined for days.

However, on cross examination, defendants' expert was forced to concede that the leading academic challengers to the efficient market hypothesis have gone on record stating that in their view efficient markets are extremely rare, if they exist at all. Indeed, the defendants' expert opined that the market for *all* Internet stocks was not efficient.

The judge in Xcelera didn't buy the defense's claim. "The position of defendants' expert suggests that market efficiency is a rare phenomenon. Whether or not that is true as a matter of pure economics, it does not function to shield defendants who mislead the public from the laws regulating securities," wrote U.S. District Judge Rya W. Zobel in granting the motion for class certification in September.

The judge correctly noted the difference between an academic dispute among economists and the Supreme Court's finding, in *Basic v. Levinson*, of market efficiency sufficient to support the uniformity of circumstance among stock purchasers needed to allow class certification.

But defense lawyers are having some successes in the class certification arena. For example, U.S. District Judge Jed Rakoff recently rejected class action status for three consolidated suits accusing Lehman Brothers of knowingly misrepresenting stock recommendations. Judge Rakoff said fraud-on-the-market theories of reliance do not apply to statements issued by analysts in the same way that they do for statements issued by a company itself.

"There is a qualitative difference between a statement of fact emanating from an issuer and a statement of opinion emanating from a research analyst," the court said. "A well-developed efficient market can reasonably be presumed to translate the former into an effect on price, whereas no such presumption attaches to the latter."

A January 20, 2005, decision of the 2nd Circuit Court of Appeals reached the same result for a different reason. In Lentell v. Merrill Lynch, the 2nd Circuit affirmed the dismissal of plaintiffs' claims that Merrill's knowingly false "buy" recommendations were actionable under the securities laws to allow investors in 24/7 Real Media and Interliant to recover their losses when the stock price collapsed.

The court's concern was that the plaintiffs had not alleged that their losses were caused by Merrill's phony buy recommendation, which could have been shown by a market reaction to a corrective statement by Merrill.

We think the analyst cases are a separate matter, and the fraud-on-the-market presumption will remain the law of the land in cases alleging fraudulent statements by corporate defendants. If this were not the case, it clearly would spell trouble for plaintiffs. Think of the magnitude of what's at stake here: If the courts tell plaintiffs' attorneys that we can't litigate these cases as class actions, then defendants will only have to worry about how many investors can file individual claims against them.

Due to the forbidding economics of that litigation, which would dissuade all but the largest investors from pursuing their claims, the securities laws would be rendered toothless, a right without a remedy. Few would say today's corporate leaders should not be answerable for their violations of securities laws. Beware of those who do, even if they are clothed in the gowns of academia. ■

Mr. Pease, a partner in the firm's Boston office and the Monitor's *executive editor, is trial counsel in the Xcelera litigation.*

Supreme Court

Continued from page 3

followed by a drop in stock price to properly allege loss causation.

In the Dura case, Broudo and a group of investors purchased Dura stock following positive statements from the company about its Albuterol Spiros inhaler. Dura later revealed, however, that the FDA was not going to approve the device. The plaintiffs argued that company officers had misled investors, trumpeting the product when they knew it had reliability problems.

"Investors have already lost billions of dollars thanks to the shenanigans of corporate wrongdoers. If the Supreme Court adopts the stricter pleading standard, investors will lose yet again."

The district court dismissed the complaint, citing a failure to properly plead loss causation between the alleged fraud and the eventual stock drop. But the 9th Circuit Court of Appeals reversed the decision, saying no such allegation was required. Loss causation, the appeals court said, "merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause."

Dura and other corporations hope the Supreme Court justices overturn that decision in favor of the more stringent loss causation pleading requirement.

"A Supreme Court ruling in favor of Dura will have a decidedly negative impact on securities cases," said C. Oliver Burt, III, a partner in Berman DeValerio's Florida office. "Such a decision would make it significantly harder for plaintiffs to recover their losses on investments in companies that violate the securities laws, giving corporate America yet another escape route for bad behavior."

Public companies should be held liable for the full range of investor stock losses – not just for losses that follow negative public announcements, Burt said. Plaintiffs' attorneys have seen countless examples of fraud cases in which a stock dropped only marginally following the announcement of accounting troubles. Yet in many of those cases, the price of the company's stock had been artificially inflated for a substantial period of time long before the problems came to light.

"Investors have already lost billions of dollars thanks to the shenanigans of corporate wrongdoers," Burt said. "If the Supreme Court adopts the stricter pleading standard at issue in *Dura*, investors will lose yet again."

Underscoring the importance of the Dura case, a number of prominent public pension funds filed *amicus curiae* briefs in the case, arguing that adopting the narrow pleading standard rejected by the Ninth Circuit in Dura would unfairly limit shareholders' abilities to sue fraudulent companies.

The Supreme Court heard arguments January 12. A ruling is expected by the summer. ■

"New from accounting, sir. Two and two is four again."

PRACTICAL MATTERS

The Roles and Responsibilities of Lead Plaintiff

Institutional investors contemplating a lead role in a securities class action often ask us the same question: "How much staff time will this cost?"

The short answer is that it depends, mostly, on you. At the very least, a lead plaintiff should be willing to work with the attorneys and vigorously pursue a case. Beyond that, a fund can determine how much effort to expend to achieve its litigation goals.

"As lead plaintiff, if your lawyers are doing their job, you can have control over a case without tying up a lot of staff time," said Joseph J. Tabacco, Jr., a partner in Berman DeValerio's San Francisco office. "The fund trustees in their role as lead plaintiffs is to provide overall supervision of the lawyers. Leave it to the lawyers as specialists to develop and execute legal arguments and strategy after receiving overall direction from the lead plaintiff."

One of a series of articles designed to help institutional investors understand the ins and outs of securities litigation and identify steps they can take to address securities fraud.

With passage of the Private Securities Litigation Reform Act of 1995 (PSLRA), Congress sought to encourage institutional investors to accept leadership roles in securities class actions. While the PSLRA is explicit on the rationale for institutional involvement and on the lead plaintiff's authority to retain counsel, it is decidedly vague on the lead plaintiff's duties and responsibilities once the case begins. For that reason, institutional involvement has been something of a work in progress when it comes to directing and managing a case.

We can tell institutional investors that taking a lead role gives you the opportunity to affect the outcome of litigation. The lead plaintiff has a duty to act not only as a fiduciary for its own plan members, but as the fiduciary for the entire class of wronged investors. That means the lead plaintiff must look out for the best interests of everybody involved. For some funds, realizing adequate monetary compensation is the primary goal of litigation. For others, achieving corporate governance reforms is equally important.

Theories vary about which funds should pursue the lead position. Some funds believe that only the largest investors, which are more likely to have the largest losses, should go after the lead plaintiff spot. Others believe that smaller funds are equally well-suited to the task. Either way, studies show that securities cases run by public pension funds have resulted in significantly higher settlements than those with individuals as lead plaintiffs.

By selecting, retaining and overseeing counsel, the lead plaintiff can ensure that the case is run in their interests. In practical terms, this means determining an appropriate fee structure with experienced and qualified attorneys to maximize any settlement benefits for investors. To put it even more simply, the lead plaintiff should try to get the best possible lawyers at the best possible price.

Beyond attorney selection, there are obvious areas where the lead plaintiff is expected to get involved. For example, the lead plaintiff must review and authorize the complaint that establishes the case against the company in question.

The lead plaintiff may wish to review and approve every legal filing in a case, but doing so isn't usually a good use of a fund's time. After all, that's why funds hire specialized outside counsel in the first place. The fund must approve the key strategic decisions made in the litigation.

> *"As lead plaintiff, if your lawyers are doing their job, you can have control over a case without tying up a lot of staff time," said Joseph J. Tabacco, Jr., a partner in Berman DeValerio's San Francisco office.*

As lead plaintiff, your fund will be required to produce any relevant documents pertaining to the purchase of the stock in question. This includes trading records as well as any information relied upon in purchasing the shares – i.e., company reports or analysts' remarks.

Continued on page 9

PRACTICAL MATTERS *continued from page 8*

In addition, the fund – most likely its executive director – may be deposed on class certification and liability issues. The court must determine whether the lead plaintiff is informed and whether the fund is truly representing the interests of the class.

The lead plaintiff need not articulate any legal theories. Rather, the fund director or his representative will simply have to state for the record who the defendants are and what they are accused of doing wrong – i.e., improperly booking revenue.

Because securities cases can take years to resolve, there will be long periods during which the fund won't have to do anything related to the class action. Counsel will provide periodic updates on motion practice and progress in discovery.

It's at the settlement phase that a lead plaintiff has its most serious and significant responsibilities to direct and approved the objectives and conduct of the negotiations.

Quite often, the lead plaintiff steers the attorneys toward a more successful result. "As attorneys, we bring our years of experience to the negotiation table in attempting to reach an appropriate settlement figure," Tabacco said. "However, our experience also teaches us that often the client brings a fresh perspective that may result in a more creative and valuable recovery for investor class members."

Settlement talks also give the lead plaintiff an opportunity to push for concrete changes at companies. By forcing companies to appoint independent board members or to expand their annual proxy disclosures, institutional lead plaintiffs can improve a company for future investors and strengthen overall financial markets.

"The bottom line is that with lawyers who are experts, the lead plaintiff need not micromange the case," Tabacco said. "The rigors of day-to-day litigation are best handled by the experts with oversight and guidance being the key elements contributed by the lead plaintiff. This joint effort will often result in the best result for investors." ■

EDITORIAL

Privatizing

Continued from page 2

of his second presidential term. Yet the degree to which the system is in trouble is very much in debate; *Washington Post* columnist Richard Cohen said the Social Security "crisis" is the domestic equivalent of Iraqi weapons of mass destruction.

Bush will certainly face a tough fight from politically savvy Democrats, organized labor and public employees. In December, for example, the California Public Employees' Retirement System, the nation's largest public pension fund, voted to oppose the privatization of Social Security. "It will only lead to higher interest rates on treasury bonds, corporate bonds and mortgages. It will give less retirement stability for workers, and result in higher costs for America's taxpayers," said Rob Feckner, vice president of the CalPERS board.

Studies have shown that defined contribution plans like those Bush wants to implement cost more to administer than defined benefit plans like Social Security – 2% verses 0.2% for CalPERS, for example. Management fees in England and Chile, which privatized their systems, are running 20 to 30 times higher.

Switching Social Security to privately managed retirement accounts will likely generate billions of dollars in business for investment firms. A happy coincidence for President Bush's Wall Street buddies? Perhaps.

While opinions vary over Social Security's long-term solvency, there's little question the system needs attention if we want it to benefit our children and our children's children. Social Security succeeded for as long as it did because of the strong ratio of workers to retirees. Thanks to increased longevity and lower birth rates, that ratio has dropped substantially, from 41 workers per one retiree in the 1930s to two-to-one over the next 20 years.

Privatization, however, is not the cure. We must find a way to reform a system that has benefited legions of retirees for seven decades. Our national health depends on it. ■

Performance

Continued from page 1

SFM: How could pay be improved?

LB: Institutional investors could use our findings to pressure boards more effectively on executive compensation. Our analysis identifies the pay arrangements that institutions should resist, and those that they should encourage. For example, investors should urge firms to use equity-based schemes that filter out windfalls, to substantially limit managers' freedom to unload equity incentives and avoid contractual provisions that provide executives with soft landings in the event of failure.

To constrain boards' ability to camouflage executive pay, the SEC should ensure that firms make the total amount of an executive's pay and its sensitivity to performance transparent to a wide range of outsiders. *Pay without Performance* proposes various changes in disclosure requirements that would increase transparency. For example, firms must be required to place a monetary value on all benefits given or promised to executives and to include them in the compensation tables.

The most promising remedy, but the one most difficult to obtain politically, would be to adopt reforms that make boards more attentive to shareholder interests. Having directors that focus on shareholder interests would produce better pay arrangements, and improved board performance in general.

SFM: How much can recent corporate reforms address past problems?

LB: Recent reforms to strengthen director independence are beneficial.But they fall far short of what's necessary. Our work shows that the new stock exchange listing requirements weaken executives' influence over directors but do not eliminate it. Moreover, increasing independence can only go so far on its own. Independence does not ensure that directors will have incentives to focus on shareholder interests, nor that directors will be well selected. Directors must not only become independent of shareholders but also dependent on shareholders. To that end, we should eliminate the arrangements that currently entrench directors and insulate them from shareholders. Such reforms offer the most promising route for improving executive compensation and corporate governance.

SFM: Do you support the SEC shareholder access proposal?

LB: I have supported this proposal in a recent *Business Lawyer* article as well as in hearings the SEC held on the subject last spring. My article put forward evidence that the incidence of electoral challenges to directors has been practically negligible in the past decade. Believing that shareholders now have the power to replace directors is largely a myth. To make directors more accountable, we need to turn this power from a myth into a reality. The SEC proposal is thus a step in the right direction — a mild step that should be supplemented with other changes.

SFM: Other changes you recommend?

LB: Getting rid of the staggered boards most public companies now have and putting up all directors for annual election. Staggered boards provide a powerful protection from removal in either a proxy fight or a hostile takeover. In a recent empirical study, Alma Cohen and I found that staggered boards significantly reduce firms' economic worth. In a subsequent study with Allen Ferrell, we identified several additional governance provisions that insulate boards from shareholders (such as limits on bylaw amendments) that correlate negatively with firm value.

In addition to making director removal viable, shareholders need to obtain the power to initiate and adopt charter amendments. I develop the case for such a change in a recent article, *The Case for Increasing Shareholder Power.* In this article, I provide evidence that boards have been avoiding governance changes that they disfavor but shareholders view as maximizing value. For example, in most of the companies where shareholder resolutions to dismantle staggered boards passed with a majority, we still have staggered boards in place. Allowing shareholders to set governance arrangements would operate over time to improve the whole range of governance arrangements without outside regulatory intervention.

SFM: How likely are these changes?

LB: There are powerful vested interests that would resist any reforms to reduce management insulation and increase shareholder power. Even the mild SEC proposal for limited shareholder power to nominate directors has garnered such fierce opposition that it remains blocked. Fundamental legal reforms in the allocation of power in public companies will not be possible unless investors and public officials fully appreciate how pervasive and costly the flaws in our corporate governance system are. I hope *Pay without Performance*, and the other work I am doing on corporate governance, will help bring about such an understanding. ■

Study: Securities Lawsuits Increase in 2004

The number of federal securities fraud class actions filed in 2004 rose 17 percent over the previous year, but remained consistent with the annual average established since Congress rewrote the federal securities laws in 1995, a new study has found.

Investors sued 212 companies last year, up from 181 in 2003, according to the report produced by Cornerstone Research and the Stanford Law School Securities Class Action Clearinghouse.

"It is remarkable that we have consistently seen around 200 filings a year for the past eight years," said Dr. John Gould, a Cornerstone vice president.

While critics had predicted that class actions would jump in the wake of the Private Securities Litigation Reform Act of 1995 (PSLRA), this latest study shows that the numbers have essentially remained stable.

"What this study underscores is that fraud is alive and well at U.S. companies and that investors continue to seek justice through the legal system, as Congress intended them to do," said Michael G. Lange, a partner in Berman DeValerio's Boston office.

The Cornerstone study also found that investors sued significantly larger companies last year, as witnessed by the large decline in the stock market values of those sued.

The stock market loss of defendant firms – labeled "disclosure dollar loss," or DDL – nearly tripled, from $58 billion in 2003 to $169 billion for cases filed in 2004.

The DDL represents the total decline in the market capitalization of defendant firms from the trading day just before the end of the class period to the trading day immediately after the end of the class period.

The dramatic 192% increase in the DDL index is due to eight lawsuits, each involving losses in excess of $5 billion. Among those sued: drug maker Merck & Co. and insurer American International Group. In 2003, by contrast, only one lawsuit involved a loss of more than $5 billion.

Merck and rival Pfizer Inc. were sued amidst concerns about their Cox-2 inhibitors. AIG and insurance broker Marsh & McLennan Cos. were sued after New York Attorney General Eliot Spitzer alleged insurance bid rigging.

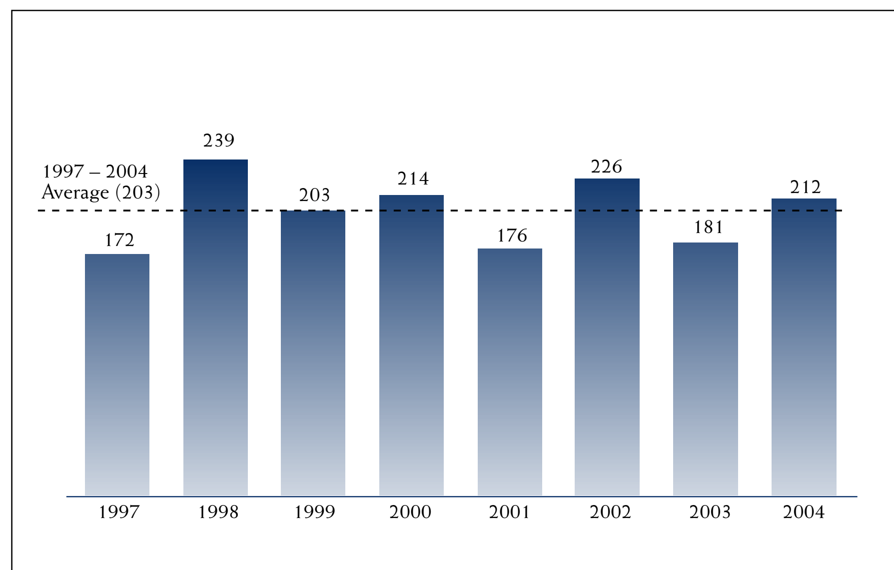
According to the study, the number of lawsuits alleging accounting violations remained relatively steady, dropping to 102 (or 48%) in 2004 from 107 (59%) in 2003.

The top three industries for securities lawsuits were consumer non-cyclical (60 cases), which includes health care, technology (37 cases) and communications firms (31 cases). Twenty-seven cases involved financial firms and 25 were in the industrial sector.

While the communications sector was among the three most frequently sued, the dollar losses for the industry dropped nearly 80%, from $240 million in 2003 to $51 million in 2004, reflecting a lower market capitalization for the communications companies sued last year.

The report also itemized the top court circuits for case filings. The Ninth Circuit (which includes California) came in first with 64, followed by the Second Circuit (which includes New York) with 45 and the Eleventh Circuit (Alabama, Florida and Georgia) with 20. ■

Securities Fraud Class Action Filings
1997–2004



Cornerstone Research and the Stanford Law School Securities Class Action Clearinghouse

Ohio Funds Lead Fraud Suit Against Fannie Mae

A federal judge has named two Ohio pension funds to represent investors in a securities fraud lawsuit against mortgage provider Fannie Mae. Berman DeValerio was named co-lead counsel.

Judge Richard Leon appointed the Ohio Public Employees Retirement System and the State Teachers Retirement System of Ohio as lead plaintiffs in the class action, which is pending in U.S. District Court in Washington, D.C. Judge Leon rejected arguments that the Ohio funds were somehow atypical investors and therefore unsuited to represent the class. Ohio Attorney General Jim Petro filed the suit on behalf of the Ohio funds, which are also lead plaintiffs in the shareholder lawsuit against mortgage giant Freddie Mac.

The high-profile lawsuit accuses Fannie Mae – formally known as the Federal National Mortgage Association – and four of its top officers and directors of issuing false and misleading financial reports to make Fannie Mae more attractive to investors. Fannie Mae is the biggest buyer and guarantor of home mortgages in the country.

According to the plaintiffs, the financial reports made Fannie Mae look like a stable investment with consistent earnings growth even though the defendants knew its earnings were highly volatile. To do so, the defendants resorted to improper accounting methods to keep earnings steady and meet analysts' projections.

The fraud drew national attention in September 2004, when Fannie Mae's regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), issued an investigative report detailing the alleged misbehavior. In a letter accompanying its report, OFHEO said Fannie Mae's management intentionally "sought to misapply and ignore accounting principles."

In December, the Securities and Exchange Commission (SEC) ruled that Fannie Mae used improper accounting and ordered the company to restate more than $9 billion in earnings reported since 2001. The U.S. Department of Justice has announced that it is pursuing a criminal investigation.

Following the SEC's ruling, Fannie Mae's board removed Franklin D. Raines, the company's chief executive officer, and former CFO Timothy Howard from their positions. Both men are named as defendants in the lawsuit. Raines' severance package, reportedly worth up to $30 million in stock and $1.37 million a year in payments, has been criticized as excessive. ■

Accounting Firms Settle Lernout Case For $115 Million

Berman DeValerio has negotiated a $115 million settlement from KPMG LLP and KPMG Belgium, one of the largest ever paid by accounting firms in a shareholder lawsuit.

The agreement settles investors' claims against the former auditors of Lernout & Hauspie Speech Products, N.V., a Belgian software company driven into bankruptcy by revelations of a massive accounting fraud.

Judge Patti B. Saris of the U.S. District of Massachusetts approved the KPMG settlement as fair, reasonable, and adequate. "You did a great job," she told Glen DeValerio and other plaintiffs' attorneys during a Dec. 20, 2004, approval hearing. Berman DeValerio is one of three firms representing the plaintiffs.

The lawsuit claimed that Lernout & Hauspie and its top executives used deceptive accounting practices to artificially inflate the company's reported revenues by an astounding 64% over two and a half years.

In obtaining the settlement, plaintiffs' attorneys faced several tough challenges. The company's bankruptcy complicated the case and removed a major source of potential money for defrauded investors. Some overseas defendants also tried to use Belgian courts to hinder the fact-finding process. At one point, they asked a Belgian court to fine plaintiffs a million euros a day for seeking discovery of KPMG Belgium.

The settlement ends litigation against KPMG. The case is continuing against other defendants, including Lernout & Hauspie's former top officers, who are currently facing criminal charges in Belgium.

Investors who purchased Lernout & Hauspie common stock on the Nasdaq Stock Market, purchased Lernout & Hauspie call options, or sold Lernout & Hauspie put options on any U.S.-based options exchange from April 28, 1998, through and including November 9, 2000 (the "Class Period"), are eligible to file claims to share in the settlement proceeds. ■