

SECURITIES FRAUD MONITOR

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The Institutional Difference: The Impact of Public Pension Funds on Attorney Fee Requests and Awards

Public pension funds that act as lead plaintiff continue to see statistical evidence that their activism makes a difference.



The latest support comes courtesy of Michael A. Perino, a professor at St. John's University School of Law and an expert on securities regula-

tion and litigation. In a paper released in December, Perino found that attorney fee requests and awards dropped significantly when public pension funds took the lead role in securities class actions.

Previous studies have found that cases with an institutional lead plaintiff settle for significantly higher sums than others. Bigger settlements plus lower fees; together, they make a compelling argument for greater institutional involvement.

Perino analyzed some 230 settlements between April 1997 and May 2005. According to his research, the mean attorneys' fee was approximately 20% of the total recovery pool in cases with a public pension fund lead plaintiff. That compared to 27% in cases with other lead plaintiffs.

Those figures, however, only reflect

the average fees in cases with and without public pension funds, and do not control for other drivers, such as settlement size. Institutions tend to get involved in the larger cases.

A better example, Perino said, is a hypothetical \$25 million settlement. Without a public pension fund, his research shows that the expected fee would be about 24.7%. With a public pension fund, the predicted fee is approximately 20.8%. That translates into a savings of about \$1 million in attorneys' fees.

Union fund lead plaintiffs, meanwhile, negotiated fees that averaged 22%, according to Perino's paper,

"Markets and Monitors: The Impact of Competition and Experience on Attorneys' Fees in Securities Class Actions."

For Berman DeValerio's editorial response, see page 2.

When controlling for settlement size and other relevant factors, however, union pension funds had no statistically significant impact on fees.

"The findings with respect to public pension funds were consistent with what I anticipated," Perino told the *Monitor*. "The public pension funds that

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Forensic Accounting Team Mines Company Documents For Corporate Scandal Clues

Securities fraud cases often hinge on the tiniest accounting details.

Lucky, then, that Van Khang and Robert Francis thrive on minutiae. They are the accounting equivalent of crime scene investigators, searching for clues to corporate crime in balance sheets, income statements, public disclosures, shipping documents and auditor work papers.

Together, the two comprise the forensic accounting team at Berman

DeValerio, one of a handful of plaintiffs' firms with such a department in-house. Berman DeValerio was one of the first firms to hire an investigative accountant full-time, beginning in 2001. Francis joined in 2003, followed by Khang a year later.

The two can cite obscure details from GAAP and GAAS (Generally Accepted Accounting Principles and Generally Accepted Auditing Stan-

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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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Taking Issue

Michael Perino of St. John's University School of Law raises some interesting points in his new study on attorneys' fees and securities class actions. His chief finding is something we have long known to be true: that institutional investors have a significant and positive impact on legal fee requests and awards.

We applaud any empirical evidence that bolsters the importance of institutional involvement. But we must take issue with some of Perino's policy recommendations.

The professor argues that public pension lead plaintiffs should be allowed to capture more than their proportionate share of a settlement. Such a scenario, he says, would encourage institutions to step forward and negotiate lower fees that benefit the entire class.

We agree that lead plaintiffs should receive compensation for their time and effort prosecuting a case to its successful conclusion. We routinely seek and receive such compensatory awards for our clients.

But there is an important difference between a compensatory award for work done and a privilege to receive a greater percentage of one's losses from the common fund. The integrity of the process and the result is called into question when the settlement fund is not equally divided among the claimants. The lead plaintiff might be tempted to settle on the cheap if it is allotted a

larger slice of the pie. Class members would be more likely to opt out and pursue their own remedies if they are not treated equally and fairly.

We also challenge Perino's recommendation to encourage auctions of lead counsel positions. Perino states that auctions might be a "second-best solution" in cases in which public pension funds do not participate and where the lead plaintiffs did not use a competitive process to choose their attorneys.

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We believe auctioning is unwise no matter the scenario. Auctioning may force a plaintiff to accept counsel with whom they have no relationship and in whom they have no confidence. Indeed, in some early auctions initiated by the courts, plaintiffs have dropped their cases rather than accept a relationship with a new, low-bidding law firm.

There are important distinctions to be made among counsel – competence, judgment, determination, financial capability, trial experience and track record. There is far too much at stake to contemplate auctioning attorney-client relationships like repossessed cars. ■

Institutions: Corporate Execs Make Too Much Money

Institutional investors think corporate executives are “dramatically overpaid” and believe there must be a stronger link between pay and company performance.

The consulting firm Watson Wyatt Worldwide surveyed 55 institutional investors, representing a combined \$800 billion in assets. The overwhelming majority – 90% – said corporate executives make too much, with 85% arguing that the hefty pay packages have hurt corporate America’s image.

Almost two-thirds of respondents said companies do not properly disclose executive compensation. (A recent Wall Street Journal report, for example, highlighted one little-known perk called “tax gross-ups.” Some major companies, including Home Depot and Coca-Cola Bottling Co., are covering large portions of their chief executives’ tax bills. Such payments, however, are typically hidden in corporate filings, the newspaper reported.)

Ira Kay, global director of Watson Wyatt’s compensation practice, said companies should be more responsive to shareholders’ compensation views. After all, institutional investors own approximately 60% of America’s major corporations.

“While many companies are making progress in addressing these concerns, boards need to do a better job of reassuring investors that they are intent on paying for performance,” Kay said.

Several shareholder groups, including Institutional Shareholder Services, TIAA-CREF and the American Federation of State, County and Municipal Employees, plan to make executive compensation a top agenda item for this year.

And in a letter sent to the Securities and Exchange Commission late last year, 10 pension funds from the United States, Canada and Europe pushed for a closer examination of the pay-to-performance issue.

The funds involved included the California Public Employees’ Retirement System, the California State Teachers’ Retirement System, two New York state pension funds, the Ontario Teachers’ Pension Plan and the State Board of Administration of Florida, according to USA Today, which obtained a copy of the confidential letter.

In the letter, the pension funds pointed to research that showed no relation between chief executive pay and company performance at many companies in the Russell 3000 index, which represents the overwhelming majority of the stock market.

Institutional investors responding to the Watson Wyatt survey said they would like to see more companies align performance with compensation. For example, a majority of respondents support offering stock options or restricted stock that would vest based on performance.

The survey also showed displeasure with executive severance packages for firings or acquisitions. About 75% described severance for involuntary termination as “shareholder unfriendly.”

A plethora of academic studies have recently demonstrated that executive compensation is ballooning. One such

analysis by Lucian Bebchuk of Harvard and Yaniv Grinstein of Cornell found that the aggregate compensation paid by public companies to their top five executives totaled some \$350 billion between 1993 and 2003 – or 10% of the aggregate profits of these companies during the last three years. These

figures do not even include the pay perks that go above and beyond salaries, such as pensions.

The Securities and Exchange Commission, meanwhile, has proposed requiring

companies to include much greater detail about executive perks and pay packages.

“Simply put,” said SEC Chairman Christopher Cox, “our rules are out of date.”

Under the proposal, annual filings would have to include tables detailing the total compensation – including stock options – for the chairman, chief financial officer and the three other highest-paid executives.

The threshold for disclosing perks would be reduced from \$50,000 to \$10,000.

Companies would also be required to provide disclosure tables for executive retirement benefits and director compensation.

Furthermore, companies would be forced to describe “in plain English” the objectives behind their executives’ pay.

At the very least, such “plain English” would go a long way toward demystifying executive pay. ■

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Case Against Fannie Mae Survives Major Hurdle

A federal judge has ruled that the shareholder litigation against troubled mortgage company Fannie Mae can proceed, rejecting defense arguments to toss out the case.

In a blow to the defense, U.S. District Court Judge Richard J. Leon ruled last month that the plaintiffs' complaint gave rise to a "strong inference" that Fannie Mae and three former officers intended to deceive investors, violat-

"The fact that the plaintiffs survived a motion to dismiss demonstrates the strength of our case against Fannie Mae and its former officers," said Jeffrey Block of Berman DeValerio.

ing accounting rules and manipulating earnings in order to meet Wall Street projections.

The Ohio Public Employees Retirement System (OPERS) and Ohio's State Teachers Retirement System (STRS) are lead plaintiffs in the case, which is being heard in U.S. District Court in Washington, D.C. Berman DeValerio is co-lead counsel.

"The fact that the plaintiffs survived a motion to dismiss demonstrates the strength of our case against Fannie Mae and its former officers," said Jeffrey Block of Berman DeValerio. "The depth of fraud at this company is simply staggering. The allegations become even more egregious when you consider that this was a government-chartered financial institution whose mandate

was promoting the American dream of home ownership."

Fannie Mae finances one out of every five American home mortgage loans.

Ohio Attorney General Jim Petro, who filed the lawsuit on behalf of the two state pension funds, called Judge Leon's decision a "great victory" for Ohio's public employees and for Fannie Mae stockholders.

"Now we will move through the discovery phase quickly to uncover the root of the fraud and bring Fannie Mae and its former officers to justice," Petro said. The two Ohio funds are also lead plaintiffs in the shareholder lawsuit against Freddie Mac, the other mortgage giant.

Details of Fannie Mae's accounting fraud have been revealed through several investigations, including a highly publicized report released late last month by former Sen. Warren Rudman. The investigation blamed Fannie Mae's former finance chief J. Timothy Howard and former controller Leanne Spencer for the accounting problems.

That report also found that Franklin Raines, the former chairman and CEO, "contributed to a culture that improperly stressed stable earnings growth." The report said that Raines "was ultimately responsible for the failures that occurred on his watch." Raines and former CFO Howard were ousted in late 2004.

Raines, Howard and Spencer are named defendants in the case.

"This latest report only strengthens what plaintiffs have been arguing all along: that top officers of Fannie Mae intentionally deceived the investing

public," Block said. "No matter how you slice it, these defendants bear responsibility."

In September 2004, Fannie Mae revealed that its regulator, the Office of Federal Housing Enterprise Over-

The report also found that Franklin Raines, the former chairman and CEO, "contributed to a culture that improperly stressed stable earnings growth."

sight, had investigated the company's accounting practices and found that Fannie Mae and its management had intentionally misapplied accounting rules to distort financial results and show "smooth" earnings growth quarter over quarter.

The investigation uncovered "clear instances in which (Fannie Mae) management sought to misapply and ignore accounting principles for the purpose of meeting investment analyst expectations; reducing volatility in reporting earnings; and enabling fragmented process and systems, and an ineffective controls environment to exist."

About two months later, the Securities and Exchange Commission ordered Fannie Mae to restate earnings back to 2001. The corrections, which should come later this year, are expected to total \$11 billion.

The class period covers those who purchased Fannie Mae stock from April 17, 2001, through Sept. 21, 2004. ■

PwC Settles Heartland Case for \$8.25 Million

PricewaterhouseCoopers recently agreed to pay \$8.25 million to settle claims connected with its auditing of two Heartland high-yield municipal bond funds. Berman DeValerio acted as lead counsel.

C. Oliver Burt III, a partner at the firm, was one of three lawyers who presented the plaintiffs' case to a federal jury in Milwaukee for 12 days. Only a small percentage of civil cases – from 2% to 4% – go to trial. The vast majority settle before ever reaching that stage.

The settlement came after each side had presented its case and as the plaintiffs prepared for rebuttal. During mediation in September, the two sides were "eons apart," said Burt, a partner in the firm's West Palm Beach office.

"We never had the viewpoint that we were going to take nickels and dimes from them just to settle," said Burt, who assumed the case would go to trial "almost from day one."

Heartland Advisors itself had previously settled with plaintiffs for \$14 million.

PricewaterhouseCoopers was the accounting firm for Heartland from 1997 through 1999. Two of the investment firm's high-yield municipal bond funds collapsed in 2000. Plaintiffs argued that the auditors should have realized that Heartland was not running the funds properly.

"Plaintiffs contended that the audits for those years did not comply with Generally Accepted Auditing Standards and that the financial statements did not comply with Generally Accepted Accounting Principles," Burt said.

The defense argued that PwC did exactly what was required for an

auditing firm.

Had the case gone to deliberations, jurors would have been expected to weigh the issue of proportionate liability – that is, how much responsibility did PwC bear for the downfall of the Heartland funds.

Given the complexities of the liability and damages issues, the \$8.25 million settlement was "a very strong result," Burt said.

Few cases ever make it to trial. Berman DeValerio prides itself on its willingness to take cases to a jury when the lead plaintiff and their attorneys believe it will benefit investors.

An interesting side note: This case was part of a special study in the Seventh Circuit on jury trial effectiveness.

Under the project, jurors could write down questions to be asked of each witness.

Following sidebar consultations with the attorneys, the judge would read the questions to the witnesses, who then had to respond. Some of the questions were sympathetic to the plaintiffs, while others were not.

"It gave you a window into what the jury's reasoning was that you don't get in most trials," Burt said.

Was it this window into the jury that prompted the defense to settle? That's impossible to determine, Burt said.

"You can't really say why they settled at that time, for that price," Burt said.

"It took the trial to get the two sides to agree. That's really all you can say." ■



Forensic Accountants

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dards, respectively) in the same way an English scholar recites verses of Chaucer. And, by all accounts, they actually like this stuff.

There's certainly plenty to keep them happily occupied.

Accounting irregularities represent the vast majority of securities fraud cases. Last year, 89% of cases alleged misrepresentations in financial reporting and 82% alleged false forward-looking statements, according to the Stanford Law School Securities Class Action Clearinghouse, which analyzes filings annually.

The two accountants – both Certified Public Accountants – have more than 20 years of combined experience. Khang and Francis spent much of their careers at Big Four firms – Francis with KPMG and what is now PricewaterhouseCoopers, Khang with Ernst & Young.

"The accounting expertise of these two individuals has been invaluable to our attorneys and to our clients," said Jeffrey Block, a Berman DeValerio partner. "We rely on Bob and Van in all phases of a case's development. They consistently impress us with their abilities to decipher the numbers and pinpoint what is often a critical element of any given fraud."

In the earliest stages of a potential securities lawsuit, the accountants help the attorneys evaluate the merits of a case. When a company restates earnings – frequently an indicator of fraud – the accountants will review corporate financials to gauge whether it was a simple mistake, a case of book-cookery or something in-between.

"We can usually tell very quickly,"

Khang said. "If there were no huge impacts to profits and losses, and if their accounting changes appear reasonable, I might suggest that we shouldn't bother to take the case."

Of course, they could also determine that it is a strong case with accounting irregularities written all over it.

The accountants frequently collaborate with Berman DeValerio's in-house team of investigators to make these determinations. (See our Fall 2004 issue for more on the firm's investigators.)

"If you're not trained, you're going to miss a document that's really hot and could make the case," Khang said.

Once a case has been filed, the accountants assist with any number of key tasks in the litigation: drafting complaints and document requests; analyzing public financial statements; preparing attorneys to take depositions; helping choose expert witnesses; and preparing for trial.

Khang is particularly suited to these efforts. At Berman DeValerio, she searches for buried bodies, an extension of what she did at Ernst & Young. In that job, Khang was part of a team of forensic accountants hired by corporate defense attorneys. Their mission: finding problems and correcting the books at companies where fraud occurred.

"I used to work for defendant companies to find the fraud," she said. "I would sit down with defense counsel and say, 'This is how we need to package this to the market.' I've seen all the frauds and how they can be hidden."

For example, she said, fraudulent record keeping at a company might be packaged to Wall Street as a "break-

down of internal controls."

"The problem with the industry is that many CEOs and CFOs were CPAs from Big Four firms, so they know how to hide things from auditors," Khang said. "A first-year auditor would never catch many of the tricks because they lack the experience necessary to understand the impact to the bottom line. The company executives are much more knowledgeable and able to pull the wool over the eyes of the inexperienced staff auditors."

Adding to the systemic problem is the fact that more experienced auditors spend very little time training and monitoring their inexperienced counterparts. This lack of guidance and oversight helps to enable fraudsters, Khang said.

"If you're not trained, you're going to miss a document that's really hot and could make the case," Khang said.

At E&Y, Khang saw it all, so she wasn't surprised by the fraud cases she has explored since joining Berman DeValerio. Francis, by contrast, was stunned, both by the depth of the accounting shenanigans at corporations and by the shoddy work of the auditors who were supposedly monitoring them.

"I was astonished at how bad the accounting work was, and how the auditing company found continuous patterns of revenue problems and ignored them," Francis said of McKesson HBOC, one of his first assignments.

The two accountants bring different skills to the firm, and cases are assigned with their backgrounds in mind.

Francis' knowledge of the mutual fund industry, for example, helped Berman DeValerio successfully prosecute the Heartland Advisors case. (The firm recently reached an \$8.25 million set-

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Securities Cases, Investor Losses Drop 17% in 2005

Securities fraud class action filings dropped more than 17% last year, falling to 176 cases from 213 in 2004, according to figures released by the Stanford Law School Securities Class Action Clearinghouse and Cornerstone Research. The rate stood almost 10% below the 1996-2004 average of 195 filings.

The report also found that investor losses decreased significantly in 2005. These losses, which were measured by the drop in a defendant firm's market capitalization at the end of the class period, fell 33%, from \$147 billion in 2004 to \$99 billion last year.

"Though filings declined in 2005, corporate fraud has not, something reflected in the record number of restatements last year. Many of the securities fraud cases filed in 2005 centered on extremely serious allegations of corporate misdeeds," said Berman DeValerio Partner Glen DeValerio.

Among the more prominent securities cases filed last year were actions alleging fraud at American International Group and Refco.

According to Glass Lewis & Co, an investment research and proxy advisory firm, an estimated 1,197 companies issued restatements last year. That's nearly double the 619 restatements for 2004. Huron Consulting, which also tracks restatements, is expected to issue its 2005 report this spring.

Stanford and Cornerstone researchers attributed the decrease in class action filings to two major factors: the end of new cases that arose from the stock bubble of the late 1990s and early 2000s, and improved corporate governance in a post-Enron, post-WorldCom environment.

In addition, last year's less volatile stock market may also have contributed to the filing decrease. "Our observations over the past decade indicate that lower market volatility tends to be associated with a lower number of filings," said John Gould, vice president of Cornerstone Research and one of the study's contributors.

The vast majority of last year's lawsuits alleged misrepresentations in financial reporting – 89% of cases – and

false forward-looking statements – 82% of cases. These were up from 78% and 67%, respectively, in 2004.

The percentage of filings alleging GAAP violations and insider trading remained relatively stable, occurring in approximately 45% of cases.

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Cases against technology and communications companies, which previously dominated the securities litigation landscape, dropped by more than 32% from 2004 levels. Instead, the majority of last year's cases were against companies in the consumer sector, such as biotechnology, pharmaceuticals, commercial services, food and healthcare products.

The report also detailed the most active federal circuit courts for the year, as measured by the number of companies sued. They were: the Second Circuit (New York), with 44 filings; the Ninth Circuit (California), with 38 filings; and the Third Circuit (Delaware/Pennsylvania), with 18 filings.

Filings dropped by a significant 41% in the Ninth Circuit, which reflects the decline in litigation against high-tech firms that are typically based in California. ■

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tlement with PWC over its auditing of two Heartland funds. See related story on p. 5.) When working at the former Coopers & Lybrand, Francis specialized in investment management audits, so he knew precisely which documents the firm's attorneys would need to prepare their arguments.

While the names and players in the securities cases change, the accounting

frauds typically stay relatively constant. After all, there are only a handful of accounts that a fraudster can play around with: revenue recognition, restructuring reserves, allowances for different accounts, and capitalization of costs that should have been expensed. Such manipulations are usually attempts to increase sales, decrease expenses and, ultimately, increase the bottom line.

"You see the same thing over and over again," Francis said. "You would think they would learn from their mistakes." ■

Attorney Fees

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have gotten involved in these cases have consistently sought to reduce fees and their efforts seem to be paying off."

Public pension funds often negotiate with plaintiffs' counsel for fee reductions, thanks largely to the competitive bidding process by which funds typically choose their litigators – one of their chief duties under the Private Securities Litigation Reform Act of 1995 (PSLRA). Historically, individual lead plaintiffs did not wield the clout to obtain lower fees.

Moreover, institutions that take

"There is considerable debate among institutions over how best to structure fees to align the interests of class and counsel.

We work with our clients to negotiate a fee agreement that will best serve the lead plaintiff and the class it represents," said, Michael J. Pucillo, a partner at Berman DeValerio

a more active role in securities litigation – Perino calls them "repeat players" – become experts at designing and negotiating lower fees with counsel, the study said.

According to Perino's research, public pension funds have also reduced fee awards, albeit in a small number of actions, by filing objections in cases where they were not lead plaintiffs. Institutions objected in only 3% of the cases Perino examined, but their impact was statistically significant. The fee for those cases averaged 18.4%, versus 26% in other cases.

Perino said he expects more institutional investors will file objections. "The institutions I have spoken to view objecting as a viable strategy, a result these findings confirm," he said. "It is also a much lower cost one than participating as lead plaintiff, so I expect to see more of it in the future."

Institutions have been finding that law firms are willing to negotiate fees.

"There is considerable debate among institutions over how best to structure fees to align the interests of class and counsel. We work with our clients to negotiate a fee agreement that will best serve the lead plaintiff and the class it represents," said Michael J. Pucillo, a partner at Berman DeValerio. "In some instances, we have agreed to voluntarily reduce our fees when the recovery was greater than expected."

Perino also studied the influence of the courts on attorneys' fees. Judges, who must approve any fee award, have expressed frustration that fee determinations are inherently imprecise because "there is no readily ascertainable market rate for the services of plaintiffs' attorneys in class actions," Perino noted in his study.

Perino found that courts that have more experience handling securities cases typically award lower fees than those with less familiarity. And contrary to several previous studies, the professor found that busier courts do not award higher fees.

Perino said his findings could be used to shape litigation policy. Among his recommendations:

- **Compensate public pension funds for lead plaintiff involvement.**

While other academics have proposed allowing lead plaintiffs to recover indirect costs as a way to en-

courage participation, Perino's proposal goes one step further: permitting public pension lead plaintiffs to capture more than their proportionate share of a settlement. The goal, he said, would be to encourage institutions to design more cost effective fee arrangements that ultimately benefit the entire class. His proposal, however, would require Congressional action because the PSLRA prohibits giving a lead plaintiff a greater interest in the common fund than the class members.

- **Urge courts to encourage institutions to file fee objections, particularly in smaller cases in which public pension funds are unlikely to be the lead plaintiffs.**

"Some courts are reluctant to award attorneys' fees to objectors because they worry that this will only encourage professional objectors to lodge frivolous or generic complaints to try to get a piece of the settlement," Perino said. "But that shouldn't be a concern when it comes to the objections that public pension funds make."

- **Encourage courts with little experience in securities class actions to seek guidance from more experienced courts when awarding fees.**

This sharing of knowledge could go a long way toward reducing judges' frustration in seeking a benchmark for fees, Perino said.

- **Continue the experiment of auctioning the role of lead counsel.**

This would most likely occur in cases where there is no public pension fund lead plaintiff, and where the lead plaintiffs did not choose their counsel by a competitive process. ■