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SECURITIES FRAUD MONITOR

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

Behind the Scenes of the Litigation Against Xerox

Where does one even begin when preparing to litigate a massive securities fraud case with millions of documents to analyze, hundreds of witnesses to interview and scores of depositions to take?

All securities class actions are complicated. But the case against the imaging giant Xerox Corp. posed some particularly daunting logistical and legal challenges.

Eight years after the first court papers were filed, Xerox and its former auditor agreed this year to pay \$750 million to settle claims that they violated federal securities laws. If the settlement receives final court approval this fall, the recovery will rank among the largest of all time.

Berman DeValerio represented the Louisiana State Employees' Retirement System, the only institutional co-lead plaintiff in the case.

The lawsuit accused Xerox of a host of top-down accounting manipulations orchestrated to inflate revenues and meet Wall Street expectations. Among the allegations: improper revenue recognition in the company's leasing division; overstated values of future payments from leases originating in developing countries; and failure to write off mounting bad debts and improperly classified transactions in its Mexico operations.

The allegedly fraudulent activities were occurring at multiple levels at

Xerox, with numerous actors, issues and accounting principles.

"There were so many ways in which plaintiffs believed the defendants were manipulating the books. Some were obvious, some not. Some were large, some small. But even the small ones can amount to significant money when they occur many times over and around the world."

"Xerox is a huge company with billions of dollars in annual sales and tens

of thousands of transactions in more than 50 countries – all with different currencies, policies and procedures," said Glen DeValerio, managing partner in Berman DeValerio's Boston office. "There were so many ways in which plaintiffs believed the defendants were manipulating the books. Some were obvious, some not. Some were large, some small. But even the small ones can amount to significant money when they occur many times over and around the world."

The Berman DeValerio team recognized early on the sheer enormity of

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Tabacco: Tellabs Is Lone "Shining Star" Among Recent Supreme Court Rulings

Almost lost among a series of pro-business decisions from the U.S.



Joseph J. Tabacco, Jr.

recent legal seminar.

Initially trumpeted as a victory for

Supreme Court, the 2007 Tellabs opinion has turned out to be "the shining star" for plaintiffs, Berman DeValerio partner Joseph J. Tabacco, Jr. told attorneys at a

defendants, the ruling is "as close to a middle-of-the-road decision as the plaintiffs bar could have asked for," Tabacco said during the American Law Institute-American Bar Association session.

Tabacco, managing partner of the firm's San Francisco office, appeared with defense attorney Jonathan C. Dickey of Gibson, Dunn & Crutcher LLP. The July 25 session was part of a Postgraduate Course in Federal Securities Law.

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BERMAN DEVALERIO PEASE
TABACCO BURT & PUCILLO

Berman DeValerio 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, union funds and other institutional investors.

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EDITORIAL

Everybody's Doing It?

The last bad boy in the Milberg, Weiss and Lerach phony client scheme pleaded guilty to obstructing the Internal Revenue Code on Bastille Day, July 14, 2008. Perhaps attorney Paul T. Selzer, who admitted to failing to report transferring \$15,000 from Milberg Weiss to its frequent-flier client Seymour Lazar, will avoid the slammer. He will probably be disbarred.

The prosecutors charged Milberg, Weiss, Lerach et al. with secretly paying illegal kickbacks to Lazar, Dr. Steven Cooperman, Howard Vogel and others from 1979 through 2005, splitting their attorney fees with their clients to

encourage them to buy stock in companies and be plaintiffs in the event that the companies were later found to have misrepresented their financial affairs.

This scheme enabled the lawyers to gain a significant competitive advantage. They routinely filed their complaints before anyone else in the plaintiffs' bar, took the leadership positions at stake, and earned hundreds of millions of dollars in resulting legal fees. Their market share of securities fraud cases was huge, nearly two-thirds of all cases filed.

On his way to jail, after admitting to the allegations, Bill Lerach told *The Wall Street Journal*, "Believe me, it was industry practice." In a submission seeking the mercy of the sentencing judge, his ex-wife quoted Lerach as telling his son, "Everybody was paying plaintiffs so

they could bring their cases. I thought I had to do it too."

No, Bill: everyone was not paying plaintiffs. Lerach did it to beat us to the courthouse and snatch the gold ring of leadership fees. We did the best we could to compete – legally. Now we know why he was so successful.

We did not and do not pay plaintiffs because it is a clear violation of the American Bar Association's Model Rules for Ethical Conduct. Rule 5.4 begins, "A

No Bill: everyone was not paying plaintiffs. Lerach did it to beat us to the courthouse and snatch the gold ring of leadership fees.

lawyer or law firm shall not share legal fees with a nonlawyer..." Could it be clearer? The rule is designed to protect the professional independence of the lawyer.

Further, in class actions the client has an obligation, to the court and to the class of shareholders the client seeks to represent, to exercise independent judgment on behalf of the class and not be a secret pawn of the lawyer. To be confirmed as a class representative, the client must make this showing through testimony and court filings. By failing to disclose the kickbacks, the client has probably committed perjury.

The lawyer has also violated his most fundamental obligation to the court by being dishonest and deceitful, presenting a compromised client as an appropriate class representative, and presenting false testimony.

As officers of the court, it is our obligation to uphold the integrity of

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Xerox Litigation

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the case and developed processes with an eye toward maximum efficiency. Work was split among three co-lead law firms. At the height of the litigation, it involved more than 100 permanent and contract lawyers. Each law firm took responsibility for particular elements of the case.

For starters, the lawyers brought in Berman DeValerio's in-house forensic accountants to explain to attorneys how the frauds were likely executed. "We had a lot of issues to sort through, with a steep learning curve. So having training up-front on accounting manipulations allowed us all to get up to speed very quickly," DeValerio said.

The legal team obtained documents in the case electronically, allowing the attorneys to review and code everything online. The electronic versions streamlined a laborious process that not long ago relied solely upon reams and reams of paper.

There were literally millions of documents to examine, from spreadsheets to sales charts to emails among Xerox employees. "But it's not as if any of these emails said: 'Let me detail how we were manipulating the books,'" said Bryan Wood, a senior Berman DeValerio associate who worked extensively on the case.

There were literally millions of documents to examine, from spreadsheets to sales charts to emails among Xerox employees. "But it's not as if any of these emails said: 'Let me detail how we were manipulating the books,'" said Bryan Wood, a senior Berman DeValerio associate.

The defense team also provided hard copies of documents – boxes and boxes of unorganized papers. Some, but not

all, mirrored the electronic versions, requiring the plaintiffs' lawyers to sift through the printed papers to ensure that nothing was missed.

While one team of attorneys analyzed the electronic documents in-depth, a second team of attorneys culled through the hard copies.

After completing the initial document review, the attorneys drafted an annotated internal memo that detailed every fraud allegation in the case.

Attorneys used this guide as an encyclopedic reference while piecing together the case against Xerox, saving time and providing important context as they drafted increasingly complicated pleadings.

Armed with Berman DeValerio's annotated fraud memo, these lawyers could home in on key documents and concepts without returning time and again to the originals – many consisting of numbers with no accompanying explanation.

The review teams – comprised largely of contract attorneys, supervised by lead counsel – grew smaller as the documents were winnowed, keeping a lid on costs.

Finally, after numerous discussions among the plaintiffs, Xerox and KPMG, its former auditor, the case was resolved after a two-day mediation. The discussions were, at times, very difficult. But the firm's mastery of the basic facts of this extremely complicated case greatly assisted in the eventual resolution.

"Xerox shareholders can feel good about the significant financial recovery, especially given the length and difficulty of this case," DeValerio said. "Moreover, we are now able to take new efficiencies we created with this case and build them into other prosecutions. We don't have to reinvent the wheel." ■



Shining Star

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In *Tellabs, Inc. v. Makor*, Justice Ruth Bader Ginsburg set a reasonable standard for reviewing motions to dismiss – a standard many plaintiffs firms had been meeting for years by investigating allegations prior to filing and providing detailed, fact-filled complaints. With Justice Ginsburg's decision, courts can now read plaintiffs' allegations holistically, Tabacco said.

"If the case passes the smell test, if you read about it in the newspaper, if you have a reputable plaintiff, such as a large institution, there's a much greater likelihood that it won't get dismissed," he said.

Over the first few months of this year, some court watchers who saw a reduction in new filings predicted the demise of securities litigation. But mid-year statistics from NERA Economic Consulting and others indicate that 2008 filings are on track to be the highest since 2002. Many of the newer cases were spawned by the subprime implosion.

Dickey called it "good news" that average settlements and median settlements are more modest than in years past.

"Where is the good news there?" Tabacco quipped. "I missed that."

"It's good news for me," said Dickey, who is the co-chair of his firm's securities litigation practice.

According to NERA, settlements during the first half of 2008 averaged \$32 million, up slightly from an average of \$31 million in 2007. But the median settlement dropped to \$6.2 million during the first six months of 2008, compared with \$9.4 million last year, Dickey said.

With the exception of some cases

tied to stock options backdating, Dickey noted that very few of the recent settlements include contributions made straight from the pockets of corporate directors and officers.

Settlements in the Enron and WorldCom cases raised fears among directors and officers that they would be held financially accountable for alleged violations at their companies, Dickey said. But those cases now seem to be the exception rather than the rule.

Tabacco agreed that such cases are rare. However, he said, some institutional investors are calling for greater personal accountability, especially in

"If the case passes the smell test, if you read about it in the newspaper, if you have a reputable plaintiff, such as a large institution, there's a much greater likelihood that it won't get dismissed."

the most egregious examples of fraud. "The [settlement] checks that get written should not be simply written by the insurance companies, but should be written by individuals," he said.

Tabacco and Dickey also spoke about the effects of this year's Stoneridge decision, which found that so-called "secondary actors" cannot be held liable for fraud. Tabacco described the case as "an example where the Chamber of Commerce finally had their way ... and, in the face of an outrageous fraud, the Court was able to insulate and draw lines against those that should be held culpable versus those that shouldn't."

At issue in *Stoneridge*: whether a company called Scientific Atlanta could be held liable by investors in a fraud case against Charter Communications.

Scientific allegedly had participated in a phony revenue scheme that helped Charter artificially inflate its financials.

While the Supreme Court found that Scientific did engage in a deceptive act, the justices said the company could not be held liable because investors had not relied upon Scientific's statements or actions when making decisions about trading Charter securities.

Both attorneys expressed surprise that some district courts have applied the Stoneridge decision to dismiss claims against corporate insiders because their conduct was never publicly disclosed to investors. Dickey predicted this will become a point of debate as these cases move into the appellate courts.

The two were also in alignment on one key element of the subprime credit crunch: the slow pace of cases. Litigation will likely take years as attorneys argue about who is responsible for the enormous losses in market capitalization.

Plaintiffs will find these cases especially difficult to prove, as a result of the Supreme Court's 2005 *Dura Pharmaceuticals* opinion, which requires claimants to demonstrate that an alleged fraud directly caused a stock price to drop. (See related article on damages calculations on p. 5.)

Dickey predicted that investors will face a "tough road" in proving that the enormous subprime market losses were directly attributable to specific defendant companies.

The decisions in *Dura*, *Tellabs* and *Stoneridge* are clear indications that the state of securities litigation and the political environment are entwined, Tabacco concluded. "If the plaintiffs don't see it, they're kidding themselves," he said. "We see more and more meritorious cases that get parsed and sliced." ■

PRACTICAL MATTERS

Damages Calculations in Securities Class Actions

By Kathleen M. Donovan-Maber

Over the last 25 years, calculating damages in securities class actions has developed into an increasingly sophisticated and highly complex undertaking. While public pension fund fiduciaries don't need to know

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.

all the nitty-gritty details behind damages calculations, understanding the

basics can be instructive, particularly for funds contemplating lead plaintiff roles.

Damages calculations are critical at several stages of securities litigation.



Kathleen M. Donovan-Maber

In the very earliest phases of a case, they can help pension funds weigh the significance of potential damages

before deciding whether to actively participate in a class action.

At the outset, funds should ask themselves a few key questions. How large are the damages in this case? \$100 million? \$1 billion? How many shares are outstanding? Did the stock drop \$1 or \$10? Was there a triggering event? Were there any external market influences?

The amount a stock's price declines is only the beginning of this analysis. A fund may initially appear to have lost large sums due to an alleged fraud, but the case is ultimately only worth pursuing if the price drop can be directly attributed to the fraudulent activities. Without that causal connection, the case won't hold up in court.

The damages calculations employed to select a lead plaintiff are by necessity preliminary estimates; they cannot be as detailed as those used in later stages of a case. This helps explain why case evaluations can differ substantially from one law firm to the next. Where one firm sees a worthy class action, another sees a claim that could be hamstrung by challenges to plaintiffs' damages calculations.

Defendants have long sought to require plaintiffs to provide damages models, also known as event studies, to demonstrate how an alleged fraud directly affected the movement of a company's stock price. The U.S. Supreme Court answered their pleas in its 2005 *Dura Pharmaceuticals* decision.

In *Dura*, the high court ruled that plaintiffs must show that a defendant's material misrepresentation or omission *caused* a stock's decline, rather than an intervening event. It is no longer enough for a plaintiff to merely allege

that the price was artificially inflated by a defendant's misrepresentation.

According to *Dura*, plaintiffs must now provide comprehensive analyses to meet the burden of

In Dura, the high court ruled that plaintiffs must show that a defendant's material misrepresentation or omission caused a stock's decline, rather than an intervening event.

establishing damages in securities fraud class actions. The evidence must show that a plaintiff's losses resulted from stock

price inflation that was caused by the defendant's misstatements or omissions.

Calculating Damages

A plaintiff's damages in a securities fraud case are usually calculated as out-of-pocket losses. These losses are expressed as the difference between the price at which the stock sold and the price at which the stock *would have sold* absent any artificial inflation caused by a defendant's alleged misrepresentations or omissions.

For many years, the courts defined damages as the difference between the price paid for the securities and the value of the securities at the time the fraud was discovered. Defendants opposed this method because it ignored outside elements impacting stock

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Calculating Damages

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price, such as overall economic and sector factors that may have been unrelated to the fraud.

In 1976, a federal appeals court judge set forth a landmark theory

for measuring damages, suggesting that the best way to measure the loss caused by a defendant's misrepresentation was through a chart showing a "price line" and a "value line."

Damages would be calculated

by subtracting the true value of the stock on the date of the purchase from the price actually paid, with the spread between the price and the value lines varying over time.

To determine the true value, lawyers began to employ the use

of event studies – statistical regression analyses that examined the effect of an event on a dependent variable, such as a corporation's stock price. This approach assumes that the price and value of the security move in tandem, except during the days when disclosures of company-specific information influence the price of the stock.

In the end, there is no one-size-fits-all approach to evaluating potential securities cases, particularly where damages calculations are concerned. Potential damages themselves are only one factor to weigh when considering whether to file for lead plaintiff.

A damages expert looks at the days when the stock price moves differently than anticipated solely based upon market and industry factors – so-called days of "abnormal returns." The damages expert then determines whether those abnormal

returns are due to fraud or non-fraud related factors.

Over time, courts began to view event studies as an accepted way to distinguish between fraud-related and non fraud-related influences on the stock. In recent years, courts have even rejected

or refused to admit into evidence damages reports or testimony by damages experts that fail to include event studies. Courts have also rejected event studies that do not comply with basic principles of corporate finance and will recognize as damages only those factors that are related to the fraud.

In the end, there is no one-size-fits-all approach to evaluating potential securities cases, particularly where damages calculations are concerned. Potential damages themselves are only one factor to weigh when considering whether to file for lead plaintiff. The opportunity to make corporate governance improvements may also influence that decision, for example. The best advice for fund fiduciaries is to approach each case individually when pondering whether to get actively involved.

Editor's Note: This article was adapted from a paper written by Berman DeValerio partners Kathleen M. Donovan-Maber and Jeffrey C. Block and associate Kyle G. DeValerio. The paper was presented to Law Seminars International this spring. ■

Editorial

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the profession and the legal process. As advocates, our success depends upon the credibility we can bring to the cases we prosecute. We at Berman DeValerio have worked very hard for 26 years to establish a reputation for integrity and excellence in the practice of law.

When our competitors violate these rules to become lead counsel, it costs us

and we don't like it. We will continue to practice law honorably even if others have not. We don't worry about doing

jail time, and neither do our clients. ■

Peter A. Pease

Berman DeValerio Adds Public Fund Clients

Berman DeValerio continues to add public employee retirement systems to its list of clients. With several recent appointments, the firm is now approved litigation counsel to the five largest public pension funds in the United States, 15 of the top 25 and more than half of the top 50. In all, the firm represents pension funds in 24 states.