

## US securities litigation – an update

**David Paterson**, NAPF Head of Corporate Governance looks at US Securities litigation with a fund approach given by **Brian Bailey**, West Midlands Pension Fund and details of a specific case from **Beata Gocyk-Farber**, a senior counsel and **David H. Webber**, an associate, with **Bernstein Litowitz Berger & Grossmann LLP** in New York.



David Paterson

As stockmarkets continue to sink and the damage wrought by the fallout from the sub-prime crisis becomes more apparent, it would be reasonable to expect an increase in litigation as shareholders seek to recover some of the losses which they have suffered in past year or so. Research published in July by Cornerstone Research (in

conjunction with Stanford Law School) does indeed confirm this. 110 suits were filed in the first half of 2008 and if this total is matched for the rest of the year, there will be a 15 per cent rise in filings when compared to the average for the past 11 years. Just over half of these cases arise from sub-prime mortgage losses and the related credit crisis. The RiskMetrics SCAS Alert prefers to focus on the other half of filings, noting: "even excluding the subprime-related filings, we expect to see substantial securities litigation activity for the rest of the year. The 'one-time' event theory does not explain the new case filing levels we are seeing and the varied types of cases that are being filed".

Interestingly, settlement values were down sharply in the first half, reflecting the lower losses incurred by investors prior to 2007/8. Cornerstone expect, based on their analysis of market movements, that there will be an increase in the value of payments as the claims lodged more recently are settled. These could compare to the losses incurred following the end of the technology bubble in 2000. Other research by NERA Economic Consulting notes that the median loss in sub-prime cases was \$4.3bn compared to \$434mn in other suits.

**"The banks were accused by the regulators of mis-selling the bonds"**

An insight into the full extent of the distress in US financial markets (and possibly its future structure) comes from the recent settlements reached by several leading banks with state and federal regulators over the failure of the auction rate securities market. These instruments, which were widely held by private investors, were regarded as very safe, liquid investments until the market effectively closed in February when dealers stopped supporting the auctions. The banks were accused by the regulators of

mis-selling the bonds and as part of the settlement were required to buy back bonds to the value of several billion dollars. Several individual investors have filed suits against firms who sold them ARS bonds, but it is not clear at this point how these will be affected by the settlements with the regulators.

**"more UK pension funds are now taking part in settlements"**

In the recent NAPF survey Pension Funds Engagement with Companies, it was apparent that more UK pension funds are now taking part in settlements: in 2007, 28 per cent of funds reported never having been involved with a class action. Respondents to the 2008 survey indicated that this figure was down to just 15 per cent. Almost three-quarters (73 per cent) of respondents had participated in a class action to collect on a settlement and 23 per cent had actively participated. Only eight funds in total had not participated in a class action settlement in the past 12 months. It would be interesting to learn whether this was due in any part to greater and more effective use of the various tracking services available to investors and to what extent trustees were holding managers to account for pursuing claims on their behalf.

**Brian Bailey, of West Midlands Pension Fund**, describes his Fund's approach as follows:

The Fund supports good governance challenging companies that do not meet best practice, perceiving poor governance as a risk to its long-term financial interests. Like many of its peers, the Fund has an SRI/corporate governance policy and supports the UN Principles of Responsible investment encouraging its external managers to do likewise.

The Fund's approach has four elements and was adopted following consultation with all stakeholders, being detailed on the website in its Socially Responsible Investment Statement 2007:

- Voting globally
- Engagement through partnerships with other concerned investors
- Active investing
- Shareholder litigation

The four areas complement each other forming one overall approach, integral to the mainstream investment management process.

Participating in shareholder litigation, where appropriate, is an effective tool and has returned over \$500,000 back to the Fund. The Fund's US lawyers and class action monitoring agent work on an on-going basis receiving a regular data stream of the Fund's holding. Relevant form filing for claims are identified by the Fund's partners. The Fund in partnership with a US lawyer, submits class actions globally where it believes that it has suffered a financial loss through fraudulent or irresponsible corporate behaviour. It recently applied to the US courts to be a lead plaintiff, but was rejected for technical legal reasons, although the Fund will still participate in the general shareholder class action.



Beata Gocyk-Farber

By way of illustration of a specific case, **Beata Gocyk-Farber**, a senior counsel and **David H. Webber**, an associate, with **Bernstein Litowitz Berger & Grossmann LLP** in New York have provided us with the following text:

The stock options backdating scandal broke in the US in mid-2006 and sparked wide-ranging investigations and the ire of institutional investors, many of whom filed civil lawsuits which alleged that - contrary to internal policies and public disclosures - executives at numerous companies granted themselves stock options by choosing the lowest exercise prices based on review of historical share prices to maximize their profits at the direct expense of the company and its shareholders.

The most egregious and widespread instance of backdating (not to mention greed) occurred at UnitedHealth Group, Inc., a leading health insurance company in the U.S, whose CEO and COO alone amassed over \$2 billion in stock options, many of them backdated. As the truth about UnitedHealth's backdating practices came to light, the stock plummeted and the company had to restate its financial statements by over \$1.5 billion.

In 2006, nine public pension funds brought suit on behalf of the company (a so-called derivative action) to recover losses caused by backdating practice. The investigation conducted in connection with the lawsuit unveiled that UnitedHealth's lack of a functioning system of corporate checks and balances had left it vulnerable. For example, UnitedHealth's CEO, and main beneficiary

of the options backdating scheme, was essentially authorized to grant himself stock options at any time and price, subject only to oral notification to the Chairman of the Compensation Committee who, as it turned out, managed as much as \$55 million of the CEO's money and served as the trustee for two trusts for the CEO's daughters. Thus, the most critical gatekeeper standing between the CEO and the company's coffers was beholden to the CEO and ridden with conflicts of interest. Nor was the CEO the only person to benefit from the fraud. In fact, backdated stock options became pervasive throughout the company. The Compensation Committee simply rubber-stamped these awards, never questioning the legality of the practice.

Bolstered by institutional shareholders' aggressive stance, certain defendants recently agreed to pay an unprecedented \$920 million to resolve the UnitedHealth derivative action. Moreover, the institutional plaintiffs are currently negotiating far-reaching corporate governance changes to ensure that future executive compensation abuses do not occur at UnitedHealth.

*The United Health Group, Inc settlement referenced is subject to court approval.*



For more key findings of the NAPF survey Pension Funds Engagement with Companies, published September 2008, turn to page 26. The full report is also available as a free PDF download at [www.napf.co.uk/Publications/researchreports](http://www.napf.co.uk/Publications/researchreports).

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