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The Rule of Institutional Investors in Securities Cases: Making A Difference by Increasing Class Recovery

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Institutional investors, particularly public pension plans, have become increasingly active in leading major securities fraud litigation since the passage of the landmark Private Securities Litigation Reform Act of 1995 (the "PSLRA"). This article will examine how the lead plaintiff provision of the PSLRA has led to a substantial increase in the percentage of recovery paid to injured investors through securities fraud litigation because of the participation of public pension systems.

THE BACKDROP: Why Securities Litigation is on the Rise

Mega securities frauds are now occurring in U.S. capital markets in numbers unprecedented in U.S. history. Many are publicized in the press. Enron may be "The Perfect Storm" — the combined corrosive effect of dishonest corporate officers, inattentive and inexperienced Boards and Audit Committees, compromised auditors and neutered securities analysts — but the number of other securities frauds involving NYSE companies is significant. Waste Management, Sunbeam, Global Crossing, Rite Aid, Xerox and Lucent all have been hit with large securities fraud claims arising out of cooked corporate books.

The root cause of these frauds is the drive of upper management to show continuous and ever-increasing profitability, increasing earnings and positive results. With these come more valuable stock options, increased compensation and job security. The ability to commit fraud and publish fraudulent financial results derives from a clear breakdown of the checks and balances which are supposed to be in place to protect investors from fraud. In essence, greed is rampant and the gatekeepers have been "out to lunch".

Auditors have become accustomed to seven figure fees. These auditors are susceptible to pressure from corporate officers who have the power to award the auditing contract and who are looking to enhance the appearance of the bottom line. The auditors are also susceptible to pressure from other divisions of their own firms, who may have lucrative consulting agreements with the companies they audit. Directors are often close associates of top management and thus lack independence. Moreover, audit committees of the board often lack independence and expertise. Most recently, Wall Street analysts stand accused of promoting stocks they know to be poor performers in order to attract or maintain investment banking business from the companies they promote. And investment bankers look the other way when faced with off-balance sheet debt or worse, they counsel clients on how to borrow funds off the balance sheet.

The Securities Litigation Players

Before the PSLRA, securities class action claims were typically brought by small shareholders controlled by lawyers. Now, six years after the enactment of the PSLRA, at least the large securities claims are being brought by sophisticated institutional investors, most often public pension plans. The following three case studies provide strong evidence of the effectiveness of institutional investors of all sizes as lead plaintiffs in securities class action claims and suggest that further activism by the institutional investor community will result in greater recoveries in the future.

Institutional Investors Taking Charge - Three Case Studies

Cendant was the most damaging securities fraud and the largest settlement in history. Lead plaintiffs were three of the largest public pension funds in the country – CalPERS, the New York State Common Retirement Fund and the New York City Pension Funds.

3Com was the largest securities fraud settlement ever in the Ninth Circuit. Lead plaintiffs were two medium sized systems, the Louisiana School Employees' Retirement System and the Louisiana Municipal Police Employees' Retirement System ("Louisiana Funds").

Assisted Living was a near bankrupt company where a $43 million settlement was reached with the company's officers and auditors. Lead plaintiff there was a smaller pension fund, the Miami Police Relief and Pension Fund ("Miami Fund").

Having these institutions of varying sizes as the lead plaintiffs made a big difference because they all made it very clear from the outset that "pennies on the dollar" settlements were a thing of the past and would not be acceptable. The prestige of the lead plaintiffs gave these funds the clout necessary to force the defendants to pay meaningful recoveries to the class. The lead plaintiffs had the human capital in the form of involved general counsel and the resolve to support a multi-year litigation. The plaintiffs in these three cases knew the importance of specialized legal skills and wanted and expected highly qualified legal representation for reasonable fees with all costs borne by class counsel.

The net result – in all three cases, class members recovered over 50% of their damages! Recoveries at this level were virtually unheard of in the past.

Cendant

Cendant was formed in December 1997 by a merger between HFS and CUC — both NYSE-traded consumer oriented companies. Four months after the merger was concluded, Cendant shocked the investment community by announcing that CUC's past financials were false. As a result, the stock price tumbled, causing billions of dollars in losses for investors.

Over fifty class actions were commenced and a number of small shareholders sought to be lead plaintiffs. The two New York systems and CalPERS formed a group and decided to proceed together as lead plaintiffs. First among their important decisions was to retain counsel of their choice at negotiated reduced fees. The Court appointed the group lead plaintiffs over dozens of others. The Court also attempted to circumvent the fee negotiations of the three systems by ordering a competitive bidding process for lead counsel. The Third Circuit, however, reversed the Trial Court, holding that retainers negotiated by sophisticated lead plaintiffs should be honored.

The litigation then moved to meaningful settlement discussions. The initial settlement demands were rebuffed by the defendants saying that no securities fraud case had ever been settled for even $500 million and that a number close to that was all the defendants were willing to pay. The pension plans played their trump card by advising the defendants, through counsel, that any settlement would have to be commensurate with the damages and the ability of the defendants to pay. Lead plaintiffs had Lazard Freres evaluate the ability to pay issue and the impact on Cendant on a going forward basis of the settlement.

Cendant agreed to pay the unprecedented sum of $2.83 billion in cash and the audit firm of Ernst & Young agreed to a record-breaking $335 million cash settlement. In addition, the Lead Plaintiffs were able to negotiate extensive corporate governance reforms and other benefits. Now, thanks to the Funds' efforts, Cendant will have an independent board and nominating, compensation and audit committees. In addition, staggered boards are now prohibited and no changes in Cendant's stock option plan can be made without shareholder approval.

Moreover, this settlement will result in a recovery to class members of approximately 50% of damages sustained.

3Com

In June of 1997, 3Com merged with U.S. Robotics. At the time, U.S. Robotics reported record financial results. Just six months later, The New York Times reported that those financial results were improper and characterized the failure to disclose $160 million in losses at U.S. Robotics as "Accounting Alchemy."

The Louisiana Funds learned of numerous class actions brought by small investors. With losses totaling $3 million, the Louisiana Funds were not content to allow the small plaintiffs to manage the case and sought appointment as Lead Plaintiff with the other shareholders. While three other shareholders were appointed along with the Louisiana Funds, only the Louisiana Funds took an active role in the three-year litigation.

Extensive litigation discovery revealed that the litigation had a number of significant trial risks. Knowing this, the Louisiana Funds' General Counsel attended all mediation sessions and was the only Lead Plaintiff to do so. This clearly demonstrated the effectiveness of an institutional plaintiff willing to participate in the litigation. Even the Court took notice of the Louisiana Funds' involvement. In fact, the Court regularly asked for the opinion of the Louisiana Funds' Counsel during the mediation sessions.

All of this resulted in a record settlement of $259 million in cash - recovering a substantial portion of investor damages, estimated at approximately 50%.

Assisted Living

In this case, the Miami Fund was the only institutional Lead Plaintiff. The case settled for $43 million against a near bankrupt company ($30 million) and the auditor, KPMG ($13 million just prior to trial). Assisted Living is one of largest securities fraud class action recoveries in Oregon history. The Miami Fund was an active participant in the settlement and litigation process.

The recovery returned approximately 60% of recoverable damages to investors.

The Moral of the Story

Before the PSLRA, when institutions were not taking an active role in securities class actions, the average recovery was 9% of damages according to a widely-cited NERA study. Now, institutional investors as lead plaintiffs make a very significant difference in the outcome of securities fraud litigation – in the examples cited above pushing the recovery rate to an extraordinary 50% or more of the damages sustained.

Today, virtually every major securities fraud case is being run by large institutional investors as lead plaintiffs. While some smaller cases are still lawyer-driven, the Assisted Living case demonstrates the effectiveness of smaller institutional investors serving as lead plaintiffs as well. Whatever the size, however, the evidence that Congress got it right in the PSLRA by favoring institutional investors as lead plaintiffs is already overwhelming.

In light of this, it is hard to understand the latest trend – Why are pension systems fighting with each other for leadership positions rather than working together?