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FIDUCIARIES BEWARE: BIG BUSINESS WANTS TO ROLL BACK NEW INVESTOR PROTECTIONS

By Tony Gelderman

"[I]f [corporate America] won't play by the rules because it's the right thing to do; then [they should] do it because it's good for business and good for the Nation's economy." So said New York's Attorney General Eliot Spitzer, in a recent *Wall Street Journal* op-ed piece. Mr. Spitzer was borrowing an elegantly simple theme from Robert Kennedy, who in the 1960's exhorted America to embrace the tenets of the civil rights movement "because it's good for business." Open accommodations, fair housing, fair credit, and non-discriminating hiring are all basic components of fair access to the consumer marketplace and thus vital to the American economy. In the same sense, transparent financial reporting, independent boards of directors and conflict-free auditors, investment banks and analysts are basic components of a properly functioning U.S. securities marketplace and thus vital to the American economy.

As the 1990s came to a close, so did the longest bull market in U.S. history. As the national markets declined, a succession of unthinkably large securities frauds came to light — frauds which were propelled by a corporate mentality of showing stronger financial results — no matter what. The steady beat of fraud disclosures finally moved from the back page to the front page with the implosion of Enron in the fall of 2001, followed quickly in the spring of 2002 by WorldCom, the largest accounting fraud ever. Institutional investors and mom-and-pop investors were both affected. It was clear to most in the securities industry that serious action was necessary to restore investor confidence in the U.S. securities markets. What ensued was far-reaching reform on Wall Street and in corporate boardrooms. However, the reform movement may be sputtering after only 36 months. In fact, certain business interests seem intent on derailing the reforms which have only recently been put in place.

Three Years of Much-Needed Reform

The corporate reform movement in many ways is personified by Eliot Spitzer, whose investigation of Merrill Lynch's stock rating system became public at about the time the WorldCom fraud hit the press. Mr. Spitzer showed the nation, in plain language, how one of the country's oldest securities firms had given its customers tainted and biased advice, simply because the firm wanted

Continued on next page.

FIDUCIARIES BEWARE...

Continued from page 1.

investment banking business from the same companies it was recommending to its customers. Mr. Spitzer's investigation led to a ground-breaking settlement severing the link between compensation for analysts and investment bankers. Merrill Lynch paid a $100 million fine. The next year, Mr. Spitzer shocked the investment world with his revelations of market-timing and late trading practices at several of the largest mutual funds in the country. And just last year, Mr. Spitzer took on the insurance industry for the payment of illegal kickbacks in return for steering business to insurance partners.

The editorial page of *The Wall Street Journal* paints Mr. Spitzer as nothing more than a politician seeking publicity. Ironically, while the editorial page has castigated Mr. Spitzer's investigations, its news reporters have reported that the U.S. Justice Department has charged more than 900 individuals in more than 400 corporate fraud cases since mid-2002. With these numbers, it strains credibility to characterize the wave of corporate fraud as "just a few bad apples."

The Justice Department has won a number of high profile convictions including John Rigas and Timothy Rigas of Adelphia and Bernard Ebbers of WorldCom, to name a few. And it is not just Mr. Spitzer and the Justice Department going after corporate wrong-doers: Manhattan District Attorney Robert M. Morgenthau has now successfully prosecuted former Tyco Chief Executive L. Dennis Kozlowski for larceny and securities fraud. Today it is understood that business executives, even businesses themselves, face a real risk of prosecution for perpetrating corporate fraud. This risk was all but non-existent just three years ago.

On the civil side of the courthouse, the list of successes in combating corporate governance failures is equally stunning.

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Consider the explosion in the number and value of meritorious securities fraud claims. In 1997, fourteen securities class actions settled for a total of $141 million. By 2004, the total number of securities class action settlements had ballooned to 132, with a total year-end settlement amount of $5.23 billion. Atop all of these cases is *WorldCom,* a class action which will generate over $6 billion for aggrieved investors. Just as stunning as the dollar amount of the *WorldCom* settlement is the fact that it includes sizeable personal payments by the former WorldCom directors, sending an unequivocal message to every public company boardroom in America: if you allow a securities fraud "too-big-to-miss" to go unchecked, you place your personal assets at risk. The *WorldCom* settlement is also expected to force investment banks to beef up due diligence before agreeing to issue debt to the public.

In addition to the criminal prosecutions and the significant civil litigation, regulatory agencies have been shaken up and reinvigorated. The passage of the Sarbanes-Oxley Act was a seminal event in the corporate reform movement, establishing the Public Company Accounting Oversight Board to implement auditors' independence standards, as well as requiring CEOs to certify the accuracy of audited financial statements. The Securities and Exchange Commission's enforcement budget has been greatly expanded and the commission, under the leadership of William Donaldson, imposed a number of large fines and disgorgements against companies engaged in serious accounting fraud, totaling $3 billion in 2004. The SEC has also successfully promulgated regulations aimed at creating independent mutual fund boards, among other initiatives.

Nevertheless, the goal of restoring full public confidence in our capital markets as honest places to invest hard earned money has not yet been achieved. After all, HealthSouth's Richard Scrushy was recently acquitted on all charges despite testimony from a number of senior executives that Scrushy directed them to participate in the fraud. The problem of continuing corporate fraud is no more evident than in the number of securities class action fraud cases filed and the losses suffered in the alleged frauds. According to a study conducted by the Stanford Law School Securities Class Action Clearing-house in connection with Cornerstone Research, securities class action lawsuit filings increased by 17% in 2004 from the previous year, while the market capitalization losses corresponding to these lawsuits almost tripled from $58 billion in 2003 to $169 billion in 2004. These statistics tell a simple truth — securities fraud on Wall Street has not peaked. The key culprits in 2004 were drug giants, insurance heavyweights and big players in the energy sector. Investors continue to get fleeced at an alarming rate and this is not a positive bellwether for long-term investor confidence, and thus the U.S. economy as a whole.

The Push Back Has Arrived

It is against this backdrop of successful criminal and civil prosecutions, as well as the continued incidents of major corporate securities fraud, that certain business interests are beginning a public relations counter-offensive, hoping to manufacture a backlash against prosecutors and litigators alike. Why? To undermine public support for prosecutions and chill the enthusiasm of shareholder activists.

The opening salvos were fired off the editorial page of *The Wall Street Journal* and from the pages of *Forbes* magazine. The themes are consistent: shareholder litigants are misguided; securities fraud cases deliver poor returns for litigants; plaintiff lawyers' legal fees are excessive; and Mr. Spitzer and his like are enemies of free markets. U.S. Chamber of Commerce President Thomas Donohue has joined in, calling Mr. Spitzer's strategy of seeking far-reaching settlements that combine reforms and fines in lieu of prosecution as "the most egregious form of intimidation that we have seen in the U.S. in a long time." And it is not just rhetoric out of the Chamber — its legal arm has filed suit against the SEC, attempting to thwart the new regulatory requirement that 75 percent of mutual fund directors be independent. Indeed, Sarbanes-Oxley, enacted in part to restore investor confidence, is now being criticized as regulation overkill. Business interests point to the high costs of compliance with Sarbanes-Oxley as justification for the need for corrections to the Act.

Most recently, Mr. Donaldson has announced his resignation as Chair of the SEC and President Bush has nominated Republican Congressman Chris Cox to replace Mr. Donaldson. Mr. Cox is viewed as sympathetic to the notion that Sarbanes-Oxley has placed undue burdens on corporate America and was a chief proponent of laws limiting securities lawsuits by private investors as a member of Congress. He should be viewed by the corporate governance community with some suspicion.

To be sure, shareholder activists have their share of columnists and commentators favorably reporting the efforts by aggressive prosecutors and lead plaintiffs. It was *Fortune* magazine that first lifted the veil of fraud at Enron. *New York Times* columnist Gretchen Morgenson, writing about the *WorldCom* class action litigation said, "Thanks to Mr. Hevesi's efforts [as lead plaintiff]…banks will probably be more apt to pick apart a company's financial state before agreeing to sell its securities. That may not sound like much, but on Wall Street, where the investors often come last, it is progress indeed."

Where Do We Go From Here?

What outcome do we really want from this environment, where prosecutors' and shareholders' litigation has mushroomed? Do critics of shareholder activists have a point when they argue that tying law abiding companies in knots of regulation does nothing more than cost shareholders money and chill innovation? Is there a kernel of truth to the assertion that institutional investors and the public are simply vengeful, seeking punishment as satisfaction? Every investor should hope not.

The battle has begun over the hearts and minds of the public, which is weary of corporate scandals but also properly suspicious of over-reaching governmental action. The political fault lines are emerging. The public will watch the ensuing battle and it will be public opinion that dictates how far corporate governance reforms will go or how far business interests will achieve a rollback. The challenge for fiduciaries today is to sift through the charges and counter-charges and to act in accordance with the best interest of their beneficiaries. This will, of course, mean filing suit to recover money lost to fraud and it will mean entering proxy fights where necessary. It will also mean speaking out if the SEC seeks to rollback Chairman Donaldson's reforms.

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An excellent question for fiduciaries to consider when embarking on corporate governance reform initiatives, such as seeking lead plaintiff status in a securities case or opposing management in a proxy issue, would be: "Is it good for business?" After all, as the owners, shareholders want business to be good.

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