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A Comparative Discussion of Private versus Government Recoveries in Securities Fraud Cases

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Introduction

Compared to other advanced economies, the United States employs a unique approach to the enforcement of its securities laws, relying on overlapping jurisdiction and authority among public and private plaintiffs. In the public sphere, regulatory agencies such as the Department of Justice ("DOJ") and the Securities and Exchange Commission ("SEC") are tasked with protecting the integrity of the markets and deterring misconduct on behalf of all investors generally, while private plaintiffs, typically institutional investors such as public pension funds, can proceed individually or on behalf of a class of investors with respect to a specific publicly-traded company and a particular set of circumstances. Regulatory bodies thus have a broader purview and an explicit goal of maintaining system integrity, while private plaintiffs can be more targeted in their approach, remaining passive investors unless and until a particular situation arises where a lawsuit needs to be filed to protect shareholders' interests. Yet where both public and private plaintiffs file suit, a direct comparison of the results can be made for purposes of evaluating the effectiveness of the two enforcement mechanisms.

The following chart and discussion make clear that the broad availability of private enforcement of U.S. securities laws has produced an enforcement regime far more effective and efficient at recovering investors' losses, and which, as a result, is essential to the maintaining the transparency and accountability forming the foundation of the robust and deeply liquid U.S. capital markets.

Private versus SEC Recoveries in Top Securities Fraud Cases

Company	Securities Class Action Recovery	SEC Recovery
Enron	$7,242,000,000	$ 450,000,000
WorldCom, Inc.	$6,156,100,670	$ 750,000,000
Tyco International Ltd.	$3,200,000,000	$ 50,000,001
AOL Time Warner	$2,500,000,000	$ 308,000,000
Nortel Networks Corp. I & II	$1,142,775,308 (I) $1,074,265,298 (II)	$ 35,000,000
HealthSouth Corp.	$ 804,500,000	$ 100,000,000
Xerox Corp.	$ 750,000,000	$ 44,000,000

American International Group, Inc.	$ 937,500,000	$ 800,000,000
Lucent Technologies, Inc.	$ 667,000,000	$ 25,000,001
Cardinal Health, Inc.	$ 600,000,000	$ 35,000,000
Adelphia Communications Corp.	$ 466,725,000	$ 715,000,000
Raytheon Company	$ 460,000,000	$ 14,700,000
Qwest Comm. International, Inc.	$ 445,000,000	$ 252,869,388
Federal Home Loan Mortgage Corp. (Freddie Mac)	$ 410,000,000	$ 50,000,000
Royal Dutch Petroleum Company/The Shell Transport and Trading Company PLC (Netherlands)	$ 389,072,515	$ 120,000,000
Bristol-Myers Squibb Co.	$ 300,000,000	$ 150,000,001
Tenet Healthcare Corp.	$ 281,500,000	$ 13,041,545
Dollar General Corp.	$ 162,000,000	$ 19,618,610
Edward D. Jones & Co., LP	$ 127,500,000	$ 75,000,000
Symbol Technologies, Inc.	$ 102,000,000	$ 37,000,001
Gemstar-TV Guide International, Inc.	$ 92,500,000	$ 22,300,000
i2 Technologies	$ 87,750,000	$ 10,000,001
Converium Holding AG	$ 84,600,000	$ 25,000,001
Total	$28,270,386,291	$4,101,529,549

Source: Securities Class Action Services

Across these twenty-three cases (which do not take into account the numerous private recoveries that lack a companion action by the SEC), private litigants recovered nearly seven times as much money for investors as the SEC. There are several good explanations for the disparity. Private plaintiffs owe their success, in part, to the distributed, privatized, market-based approach to enforcement. This is the approach whereby the prerogative to file suit is allocated across all shareholders, the decision to file suit is made according to private economic considerations (*i.e.*, evaluating the prospects of obtaining a meaningful recovery), and where there exists competition between plaintiffs for appointment as lead and among law firms for contingency representation to ensure properly aligned incentives and vigorous, skillful representation. These characteristics of the private enforcement mechanism are quintessentially American, and do not have a counterpart of similar stature in Europe or elsewhere. Among the most salutary impacts of this regime is the development of private sector expertise in the appraisal and enforcement of property rights. Over time, and especially since enactment of the Private Securities Litigation Reform Act ("PSLRA") in 1995, private plaintiffs and their counsel have become increasingly sophisticated and have built up considerable institutional knowledge in this field.

The DOJ and SEC can attribute their comparative lack of success to several factors. For one, the DOJ and SEC have broader responsibilities than private litigants, and even though equipped with additional powers, their resources have been compromised by a prolonged funding shortage. The funding problem is especially acute at the SEC, where budgetary constraints hamper the agency from fulfilling its most basic obligations. SEC Chairperson Mary Schapiro recently stressed that budget constraints were thwarting the agency's ability to enforce the securities laws, and House Representative Barney Frank (D-Massachusetts) emphasized that the SEC is unable to carry out its mandate at its current rate of funding, which has been held steady for fiscal 2012. Meanwhile, the Dodd-Frank financial reform legislation has increased the SEC's responsibilities, further straining its ability to satisfy its obligations to the investing public.

Another factor that may diminish the effectiveness of the SEC and DOJ is the notion of regulatory capture, whereby the revolving door of personnel between the government and private sector provides the regulated companies with a direct line of advocacy, ensuring a sympathetic regulatory ear while at the same time obscuring the duty owed to the investing public. The practice of skilled high-level public employees gaining significant experience only to join their former private sector charges, and in the converse, private sector employees taking government regulatory positions to oversee their former peers, is a known problem that has yet to be adequately addressed. For instance, between 2006 and 2010 the non-profit Project on Governmental Oversight found that 219 former SEC employees had filed 789 post-employment statements indicating their intent to represent an outside client before the commission.[2] And in practice, the SEC has repeatedly exempted large Wall Street firms from punishments specifically designed to apply to fraud cases.[3]

Specific Examples of Contrast between Public and Private Enforcement

Whatever the structural reasons, criticisms abound regarding the approach taken and the results achieved by DOJ and SEC in several particular cases. For example, the Honorable Jed S. Rakoff of the Southern District of New York criticized the SEC for its attempted settlement of charges that Bank of America failed to disclose key information to investors in connection with its acquisition of Merrill Lynch ("Merrill"), including that Merrill was on the brink of insolvency (necessitating a massive taxpayer bailout), and that Bank of America had entered into a secret agreement to allow Merrill to pay its executives billions of dollars in bonuses prior to the close of the merger regardless of Merrill's financial condition. The SEC agreed to settle its action against Bank of America for $33 million in August 2009, even though its acquisition of Merrill resulted in what The New York Times characterized as "one of the greatest destructions of shareholder value in financial history."[4] In rejecting the deal, Judge Rakoff declared that the proposed settlement failed to "comport with the most elementary notions of justice and morality."[5] Judge Rakoff described the agreement as a "contrivance designed to provide the SEC with the façade of enforcement and the management of the Bank with a quick resolution of an embarrassing inquiry."[6] When the SEC later submitted a revised $150 million settlement for approval, Judge Rakoff reluctantly approved the agreement while "shaking [his] head," explaining that it was "paltry" in nature and "[w]hile better than nothing, [was] half-baked justice at best."[7]

Similarly, the Honorable Ellen S. Huvelle of the District of Columbia criticized the SEC's $75 million settlement of its charges that Citigroup concealed $40 billion of subprime exposure from investors. As part of the agreement, the SEC fined two Citigroup executives a combined $180,000, though former CFO Gary Crittenden alone pocketed $19.4 million during the time of his alleged wrongdoing. Judge Huvelle questioned the fairness of the deal, and questioned why the SEC failed to pursue claims against other Citigroup executives. Strikingly, the SEC did not require any defendant to admit to wrongdoing, leading Judge Huvelle to remark that "[t]here's nothing in here to address a flawed system; not a thing."[8]

Likewise, in the $3 million settlement agreement in 2011 between the SEC and Vitesse Semiconductor and former executives over the improper accounting of revenue and the backdating of stock options, Judge Rakoff lamented the SEC's routine acceptance of language that defendants "neither admit nor deny wrongdoing," stating that "the public will never know whether the SEC's charges are true, at least not in a way that they can take as established by these proceedings."[9] In fact, the "neither admit nor deny" language has lately become a lightning rod of controversy, with Judge Rakoff forcefully striking down the inclusion of such language in the SEC's most recent settlement with Citigroup. The SEC filed suit against Citigroup in 2011 for failing to disclose to investors its role in selecting – and then secretly betting against – the underlying investments in a $1 billion mortgage-bond deal called Class V Funding III. Investors ultimately lost $700 million when these investments soured. In mid-2011, the parties reached a $285 million settlement, which included a $95 million penalty, and the familiar language that Citigroup "neither admits nor denies" the allegations.

The SEC's argument in favor of including such language is that it theoretically allows the SEC to extract significant financial restitution and penalties from a defendant while conserving for other meritorious cases the resources that would otherwise be required to extract an admission of wrongdoing. But, according to Judge Rakoff, the elevation of such language to boilerplate status is a practice that may be "hallowed by history, but not by reason."[10] Judge Rakoff wrote that the SEC, unlike a private party, has an obligation to serve the public interest, and that because the Citigroup case "touches on the transparency of financial markets whose gyrations have so depressed our economy and debilitated our lives, there is an overriding public interest in knowing the truth."[11]

Robert Khuzami, director of enforcement at the SEC, said the ruling "ignores decades of established practice throughout federal agencies and decisions of the federal courts,"[12] though one of the SEC's own Commissioners, Luis Aguilar, recently did admit the general proposition that the SEC's penalty guidelines are "seriously flawed" and have "adversely impact[ed]" civil enforcement actions.[13] Indeed, Senator Charles Grassley, an Iowa Republican serving on the committee overseeing the SEC, questioned why the SEC was requesting more enforcement powers when the agency "makes already weak punishment even weaker by waiving regulations that impose significant consequences on the companies that settle fraud charges."[14]

In any event, the impact of Judge Rakoff's ruling, though not binding on other courts, appears to be spreading. When confronted with a similar settlement less than a month later, Judge Rudolph T. Randa of the Eastern District of Wisconsin cited Judge Rakoff's ruling in a letter challenging the SEC to provide "a written factual predicate for why it believes the court should find that the proposed final judgments are fair, reasonable, adequate and in the public interest."[15]

Private Enforcement Expands its Role

In the face of these shortcomings, private plaintiffs have in fact been filling the void. For example, in the federal government's investigation into Lehman Brothers, it appears there will be no civil or criminal charges filed against former executives based on the collapse of the investment firm in 2008. According to sources cited by The Wall Street Journal, SEC officials are doubtful that they can demonstrate that Lehman violated the securities laws through its infamous "Repo 105" accounting maneuvers, through which Lehman exchanged certain assets for cash directly before reporting quarterly results, promising to repurchase the assets after filng the reports with the SEC. By contrast, institutional investors filed suit against the company, its senior management and directors, as well as a host of underwriters and the auditor in 2008, and achieved a $516 million recovery on behalf of a class of investors that is now awaiting the Court's final approval in April of this year.[16]

In fact, it has been recognized for some time that private shareholder lawsuits have a unique role in enforcing securities laws in the United States. Nearly 20 years ago, then-SEC Chairman Richard Breeden told federal lawmakers that budgetary limitations meant that private class actions must "perform a critical role in preserving the integrity of our securities markets."[17] A few years later, Breeden's successor, Arthur Levitt, admitted that private lawsuits, rather than government prosecutions, had become "the primary vehicle for compensating defrauded investors."[18] But quite significantly, in recent years there have been several high profile examples where private plaintiffs have actually led the way for the public enforcement agencies.

For example, in connection with its grand jury investigation of the alleged wrongdoing at Washington Mutual, Inc. ("WaMu"), the U.S. Attorney's Office for the Western District of Washington reportedly made use of the facts detailed in the lead plaintiff's complaint: "In the ongoing criminal investigation of Washington Mutual, for example, federal authorities admit that they are utilizing evidence emerging from a massive shareholder class-action lawsuit against the thrift and its officers."[19] Similarly, in March 2011 the DOJ indicted Wellcare's former CEO Todd Farha, former CFO Paul Behrens, and former general counsel Thaddeus Bereday, with the SEC following suit in January 2012, asserting essentially the same fraud allegations as contained in the private plaintiffs' complaint filed in 2007. This private suit resulted in a $200 million settlement that was granted final approval in May of 2011 by the Honorable Virginia H. Covington of the Middle District of Florida.[20]

Conclusion

A review of recent experience confirms and emphasizes what has been recognized by courts and Congress for some time, namely that meritorious private securities litigation is "an indispensable tool with which defrauded investors can recover their losses[,]…promote public and global confidence in our capital markets and help to deter wrongdoing."[21] In the foreseeable future, we expect institutional investors' leadership to continue providing more vigorous prosecution of securities fraud, superior recoveries, and a stronger message that such misconduct will not go unchecked.

(Endnotes)

1 Jerry Silk is a partner in the New York office of Bernstein Litowitz Berger & Grossmann LLP; John Alden Meade is an associate in the firm's New Orleans office. BLB&G has been the lead or co-lead counsel in several of the cases discussed herein, including *In re Lehman Brothers Equity/Debt Sec. Litig.*, Nos. 08-cv-5523-LAK, 09-md-2017-LAK (SDNY); *In re Washington Mutual, Inc. Sec. Litig.*, No. 07-cv-1809-MJP (W.D. Washington); and *Eastwood Enterprises LLC v. Todd S. Farha, et al.*, (Wellcare), No. 07-cv-01940-VMH (M.D. Florida).

2 *See*, "Revolving Regulators: SEC Faces Ethics Challenges with Revolving Door," Project on Government Oversight (May 13, 2011), available at http://www.pogo.org/pogo-files/reports/financial-oversight/revolving-regulators/fo-fra-20110513.html.

3 *See*, Edward Wyatt, "SEC Is Avoiding Tough Sanctions for Large Banks," New York Times (February 3, 2012), available at http://www.nytimes.com/2012/02/03/business/sec-is-avoiding-tough-sanctions-for-large-banks.html.

4 *See*, Rob Cox and Lauren Laughlin, "Bank of America's Difficult Choice," The New York Times (January 26, 2009), available at http://www.nytimes.com/2009/01/27/business/27views.ready.html.

5 Memorandum Order, *SEC v. Bank of America Corp.*, No. 1:09-cv-06829-JSR (SDNY), Docket No. 22, at 4.

6 *Id.* at 8.

7 Opinion and Order, *SEC v. Bank of America Corp.*, No. 1:09-cv-06829-JSR (SDNY), Docket No. 96, at 11, 14.

8 Hearing Transcript, *SEC v. Citigroup, Inc.*, No. 1:10-cv-01277-ESH (DDC), Docket No. 20, at 32.

9 Opinion and Order, *SEC v. Vitesse Semiconductor Corporation, et al.*, No. 1:10-cv-09239-JSR (SDNY), Docket No. 59, at 8.

10 Opinion and Order, *SEC v. Citigroup Global Markets, Inc.*, No. 1:11-cv-07387-JSR, Docket No. 33, at 9.

11 *Id.* at 15.

12 *See*, Robert Khuzami, "Public Statement by SEC Staff: Court's Refusal to Approve Settlement in Citigroup Case," U.S. Securities and Exchange Commission Press Release (November 28, 2011), available at http://www.sec.gov/news/speech/2011/spch112811rk.htm.

13 *See*, Luis Aguilar, "Speech by SEC Commissioner: Sustainable Reform Prioritizing Long-Term Investors Requires the Right Orientation," U.S. Securities and Exchange Commission Press Release (February 5, 2010), available at http://www.sec.gov/news/speech/2010/spch020510laa.htm.

14 *See*, *supra*, n. 3.

15 *See*, Letter from the Court to Plaintiff's counsel, *SEC v. Koss Corp., et al.*, No. 2:11-cv-0991-RTR (E.D. Wisconsin), Docket No. 5, at 1.

16 *In re Lehman Brothers Equity/Debt Sec. Litig.*, Nos. 08-cv-5523-LAK, 09-md-2017-LAK (SDNY).

17 *See*, Remarks of Richard C. Breeden, given October 16, 1991 to the Corporate Counsel Institute, Chicago, Illinois, available at http://www.sec.gov/news/speech/1991/101691breeden.pdf.

18 Testimony of SEC Chairman Arthur Levitt before the Subcommittee on Telecommunications and Finance, Committee on Commerce, U.S. House of Representatives, February 10, 1995, available at http://www.sec.gov/news/testimony/testarchive/1995/spch025.txt.

19 *See*, Douglas L. Davies & Laura Marquez-Garrett, "Financial Misconduct is Not Just a Civil Matter," U.S. BANKER (June 2009), available at http://www.americanbanker.com/usb_issues/119_6/-380011-1.html.

20 *See*, Alison Frankel, "Long after $200 million class settlement, SEC sues Wellcare Execs," Thomson Reuters News and Insight (January 11, 2012), available at http://newsandinsight.thomsonreuters.com/Legal/News/2012/01_-_January/Long_after_$200_mln_class_settlement,_SEC_sues_Wellcare_execs.

21 The Securities and Exchange commission Amicus Curiae Brief *Slayton, et al. v. Am. Express Co.*, et al., No. 08-5442-cv , January 21, 2010 Citing: H.R. Conf. Rep. No. 104-369, at 31 (1995).

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