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INSTITUTIONAL INVESTOR

Advocate

A SECURITIES FRAUD AND CORPORATE GOVERNANCE QUARTERLY

AGGREGATION...

DO TOO MANY COOKS SPOIL THE BROTH?

by John P. ("Sean") Coffey

In the first issue of this publication, we explored Congress' rationale behind the lead plaintiff provisions of the Private Securities Litigation Reform Act of 1995 (the "PSLRA"). *See* "Institutional Investors As Lead Plaintiffs: Is There A New And Changing Landscape?" on page 1 of *Institutional Investor Advocate,* Volume 1. That article discussed how Congress sought to ensure more effective representation of investors by encouraging a shareholder with a substantial stake in the litigation—preferably a large institutional investor—to step up to the plate and take control of the litigation as lead plaintiff. These lead plaintiff provisions were intended to take control of shareholder litigation away from lawyers (who in pre-PSLRA cases often had more financial interest in a case's outcome than the nominal plaintiff) and shift it to substantial and sophisticated investors who were capable of exercising control over counsel. Although the PSLRA sets forth a number of standards for selection of lead plaintiffs, the criterion that has sparked the most controversy is the presumption that the "person or group of persons" with the largest financial interest in the case is most adequate for appointment as lead plaintiff. This article examines recent case law interpreting what the phrase "person or group of persons" means in light of the phenomenon of "aggregation," which some courts, and the Securities and Exchange Commission (the "SEC"), view as a threat to the goals that the lead plaintiff provisions were intended to achieve.

As noted above, the lead plaintiff provisions embodied Congress' intent to shift control of securities litigation from lawyers to investors. The House, Senate, and Conference Committee reports on the PSLRA show that Congress was concerned that lead plaintiffs in securities cases often had little at stake economically in

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INSIDER TRADING...

THEY KNOW SOMETHING YOU DON'T

By Ryan D. Poliakoff

> *Is it a case of illegal insider trading or just business as usual?*

Before passage of the Securities Act of 1933 and the Securities Exchange Act of 1934, "sure thing" speculation and insider trading had been accepted by the investing community as part of the benefit of serving as a corporate officer or director. The prevailing attitude was "buyer beware" and, as such, the government did little to protect the interests of the outside investor. However, by 1933, following both the market crash and the Great Depression, insider trading had become properly recognized as a flagrant violation of an officer's or director's fiduciary duties to their corporation and its stockholders. As the Supreme Court recognized in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, the Securities Act of 1933 and the Securities Exchange Act of 1934 were passed in "response to widespread abuses in the securities industry," substituting "a philosophy of full disclosure for the philosophy of caveat emptor."

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AGGREGATION...
Do Too Many Cooks Spoil the Broth?

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how a case was prosecuted and resolved, and indeed often found themselves "running" a case as lead plaintiff merely because their lawyers won the much-maligned "race to the courthouse" and filed the first complaint. Accordingly, the real parties in interest in these cases were typically lawyers, whose financial stake in the case would far exceed that of the lead plaintiff. Among the problems traced to this situation was lack of control by the plaintiffs, with frequent procedural abuses by unrestrained lawyers as well as settlements that served the lawyers better than the shareholders. Through the PSLRA, Congress intended to stop the "first to file" race and its accompanying shortcomings, and put in place a mechanism "to encourage the most capable representatives of the plaintiff class to participate in class action litigation and to exercise supervision and control of the lawyers for the class." In Congress' estimation, if the plaintiff with the largest financial interest in the case were appointed to oversee the litigation, that investor would have sufficient sway, sophistication, and incentive to supervise the lawyers meaningfully, with resulting benefits for the investor class and fewer abuses of the litigation process.

A Hypothetical Scenario

Assume that as a result of alleged corporate misconduct, shareholders lose $100 million in the value of their shares. Many file suit. One plaintiff is a pension fund that lost $1 million, by far the largest loss of any single investor. The remaining plaintiffs are individuals, none of whom has a loss is excess of $50,000. Assuming each of the plaintiffs satisfies all prerequisites for the lead plaintiff role, if the pension fund and nine other investors each apply to be lead plaintiff, who should get the nod?

In this admittedly stark example, one could reasonably predict that the pension fund would be selected. To apply Congress' reasoning, as the investor with the largest loss, the pension fund would have the most compelling financial motivation to advance the interests of the class, and to supervise plaintiffs counsel in that endeavor. Moreover, selecting the pension fund would also be consistent with Congress' preference for institutions as lead plaintiffs.

According to the Conference Report, Congress "intend[ed] that the lead plaintiff provision will encourage institutional investors to take a more active role in securities class action lawsuits"

Inside Look

In Volume 1, First Quarter of the *Institutional Investor Advocate*, we explored the Private Securities Litigation Reform Act (the "PSLRA") and focused on Congress' intention to curb perceived abuses in securities class actions and facilitate the ability of institutions to be appointed lead plaintiff in those cases. As institutions become increasingly more active in the securities class action arena (and they have), they face significant challenges from the traditional class action bar through the practice of aggregation.

BLB&G Partner Sean Coffey picks up where our first article left off and explores the aggregation battles being waged in courts throughout the country in his article **"Aggregation . . . Do Too Many Cooks Spoil the Broth?"** His article focuses on how the various courts are interpreting the lead plaintiff provisions of the PSLRA and provides a glimpse of what lies ahead. Without giving away the ending, institutional investors are winning.

Our second feature explores insider trading, an issue near and dear to the hearts of all investors—institutional and individual. BLB&G Associate Ryan Poliakoff asks what every investor wants answered: When is it illegal insider trading and when is it just business as usual? In his article entitled **"Insider Trading . . . They Know Something *You* Don't,"** Ryan makes it clear that there is no simple answer and that a prudent investor must examine all apparent circumstances. However, when a number of key insiders sell large amounts of stock all at the same time, it is time to sit up and take a second look. Ryan provides some web sites to help with that evaluation.

Also, don't miss the **Eye On The Issues** section. Associate Rochelle Feder Hansen, our ever vigilant observer, updates the stories that made the news in previous issues of the *Advocate*. There are a few surprises, especially with audit committee issues. If you can't follow up with the original event because you lost or misplaced a previous issue—or just want another copy of a favorite story, please call us at 1-800-380-8496 or send us an E-mail: blbg@blbglaw.com. We enjoy hearing from you and will be happy to send a replacement issue.

Finally, we would like to begin featuring articles written by you—our readers—on topics you believe are relevant to the institutional investment community. If you are interested in writing a piece for the *Advocate*, just let me know.

Max W. Berger

because "increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions." In this example, then, picking the pension fund complies with the spirit

One can fairly describe "aggregation" as a practice in which individual shareholders with no relationship before the litigation pool their relatively small losses into one larger loss so they can claim to be a "group of persons" with the largest financial interest in the litigation.

as well as the letter of the PSLRA. Things may not be so clear, however, if "aggregation" becomes a factor in the lead plaintiff selection process.

Strangers in the Field

First, a definition. While reasonable minds can disagree about its precise contours, one can fairly describe "aggregation" as a practice in which individual shareholders with no relationship before the litigation pool their relatively small losses into one larger loss so they can claim to be a "group of persons" with the largest financial interest in the litigation. To illustrate this with our hypothetical, assume that the lawyers for one of those nine individual plaintiffs assembles a group of fifty shareholders (again, with no individual loss exceeding $50,000), that those shareholders declare themselves a "group," that the group files a motion to be appointed as lead plaintiffs, and that the sum of their individual losses is $2 million. Have they formed a "group of persons" with a loss that, under the PSLRA, makes them a more adequate plaintiff than the pension fund with the $1 million loss? Or how about the alternative scenario in which no institutional investor has stepped forward, but rather one group of individual shareholders competes with another group? Should the court simply compare the competing totals and conclude, as the PSLRA language appears to command, that the "person or group of persons" with the largest loss is the most adequate plaintiff? Or should the court scrutinize the characteristics of the proposed "group" to see if the aims that Congress sought to advance would be served by that group's appointment?

There are no "bright line" answers to such questions yet, but recent cases suggest that some general principles may be evolving. The courts, commentators, and the SEC all seem to agree that the interpretation of the PSLRA's "group of persons" term is the most important open question regarding the lead plaintiff provisions. The debate centers on what Congress meant by "group of persons" and whether the gathering of so many individuals who had little or no affiliation prior to the litigation will advance the aims Congress had in mind when it created the lead plaintiff provisions.

Some Early Decisions

In several early PSLRA cases, some courts took a strict view of the PSLRA language, and refused to read into the wording of the statute a numerical limitation on how many persons could be in a group. This was particularly so in cases in which only one lead plaintiff motion was filed on behalf of a "group" of otherwise unrelated investors. See, for example:

In Congress' estimation, if the plaintiff with the largest financial interest in the case were appointed to oversee the litigation, that investor would have sufficient sway, sophistication, and incentive to supervise the lawyers meaningfully, with resulting benefits for the investor class and fewer abuses of the litigation process.

- *In re Ride, Inc. Securities Litigation (W.D. Wash. 1997):* "On its face this language calls for aggregation. Any suggestion to the contrary, based on legislative history, cannot prevail against the statute's plain wording."
- *In re Read-Rite Corp. Securities Litigation (N.D.Cal. 1997):* "Although the plain language of the Act does not expressly allow or prohibit such a pooling of shares, nothing in the text prevents the aggregation of shares by the Proposed Lead Plaintiffs to constitute the largest financial interest."
- *D'Hondt v. Digital, Inc., (D. Minn. 1997):* "In our view, when, as here, the putative class may total in the hundreds of thousands, if not millions, an arbitrary limit on the number of proposed Lead Plaintiffs would be unrealistic, if not wholly unproductive."

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Insider Trading...
They Know Something You Don't

Continued from page 1.

Under the federal securities fraud statute, any "insider" has an affirmative duty to disclose any material information if he or she should trade in his or her company's securities. Corporate "insiders" include officers, directors and controlling shareholders, but this list is not exhaustive. The term "insider" describes any person who has a duty arising from that person's access to information available only for corporate purposes. If any insider should buy or sell stock in their company on knowledge of non-public material information, they have committed securities fraud.

Insider trading undermines investor confidence and its elimination is one of the priorities of the Securities and Exchange Commission. While insider trading is illegal in and of itself, it can also serve as evidence of other, unrelated fraudulent activities in a corporation. In a securities fraud action brought under Section 10(b) and Rule 10b-5 for material misstatements and omissions, the plaintiff must establish that each defendant acted with an intentional or reckless state of mind. Proof of insider selling may be strong circumstantial evidence that the corporate managers knew that something was wrong with their company and, therefore, acted recklessly or intentionally, if disclosure of negative news by the company followed shortly on the heels of the stock sales.

Similarly, evidence of insider trading can demonstrate that the alleged wrongdoer had a motive and opportunity to commit fraud. Under section 10(b), establishing motive and opportunity serves as an alternative to proving circumstantial evidence of conscious behavior. The existence of rampant insider trading can demonstrate that individual defendants had a reason to falsely inflate the value of their stock. In *Stevelman v. Alias Research Inc.,* the court recognized that insider trading "is probative of motive, which we have recognized supports a strong inference of fraudulent intent." In short, proof of unusual insider trading will often support an inference of bad faith.

> *If executives should sell large portions of their stock in a short period of time, it may indicate that they know information that the public does not — and such information is not likely to be good.*

Unfortunately, "unusual" insider trading is not always easy to ferret out. It is quite common for executives to sell shares of a well-performing stock, and such sales do not necessarily indicate that the stock is overvalued. However, sales by those insiders with the greatest knowledge of the overall affairs of the company—the CEO, CFO, president, vice presidents and directors—are often successful predictors of abnormal stock prices in the future. If these executives should sell large portions of their stock in a short period of time, it may indicate that they know information that the public does not—and such information is not likely to be good. Institutional investors would be well advised to be aware of both historic and recent insider trading patterns of all public companies in which they are planning to make a significant investment.

In determining whether insider sales are unusual, a court will consider three factors: 1) the amount and percentage of shares sold by insiders, 2) the timing of the sales, and 3) whether the sales are consistent with the insiders' prior trading histories. If the president of a corporation has sold 10 percent of his holdings every December for the past 10 years,

Bernstein Litowitz Berger & Grossmann LLP

Bernstein Litowitz Berger & Grossmann LLP prosecutes class and private actions, nationwide, on behalf of institutional and individual investors. Founded in 1983, the firm's practice concentrates in the litigation of securities fraud; corporate governance; antitrust; employment discrimination; and consumer fraud actions. The firm also handles, on behalf of major institutional clients and lenders, more general complex commercial litigation. The firm's client base in securities fraud and corporate governance litigation includes large public pension funds and other institutional investors.

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his Christmas sales this year should provide no reason for investors to panic. If that same president should suddenly dump 50 percent of his holdings, and other directors and officers do the same, it is time to take notice.

An important consideration involves the distinction between sales of options and sales of open market securities. In the modern corporate world, stock options are a common form of supplemental compensation. A stock option affords an executive the opportunity to purchase shares of a company at a pre-set price. It is believed that payment in the form of options encourages executives to be mindful of their responsibility to optimize shareholder value. The question, however, is whether an executive's vested stock options should be counted when determining that executive's total securities holdings for purposes of determining the total percentage of stock sold?

Many of today's wealthiest executives — on paper — have almost all of their wealth in stock options. Therefore, it may be that non-options transactions provide the best indication of an insider's true feelings about the company's financial health.

In the case of *Silicon Graphics,* the court held that, because vested stock options can be quickly converted to shares and then immediately sold, they must be included in determining an insider's *total* trading potential. Plaintiffs, in contrast, often argue that options are not shares, and should not be treated as such in determining whether a corporate insider has dumped a substantial portion of his company's stock. Because stock options often make up the vast majority of a corporate executive's total securities holdings, it is not uncommon in today's high-flying Internet companies for a substantial portion of an executive's total compensation to be in the form of stock options. It would not be surprising, therefore, if that executive should sell 10 percent of her options in order to convert some of her newfound wealth into cash. Many of today's wealthiest executives *on paper* have almost all of their wealth in stock options. Therefore, it may be that non-options transactions provide the best indication of an insider's true feelings about the financial health of his company.

Executive options are essentially risk-free, as they can be repriced by the corporation every time stock prices fall. Take, for example, the options repricing after the disclosure of the fraud perpetrated at Cendant Corporation. Cendant was created through the merger of two companies: CUC International, Inc., which specialized in consumer services, and HFS, Inc., which specialized in hospitality services. The merger between these two companies became effective on December 17, 1997. The merger closed even though CUC had prevented HFS from performing required substantive financial due diligence. On April 15, 1998, Cendant disclosed that it would restate its 1997 financial results, and perhaps those of earlier periods, as a result of accounting irregularities at former CUC business units. It was later revealed that CUC had engaged in a massive accounting fraud, which is alleged to have existed since 1995. It is further alleged that this fraudulent scheme involved reversals of merger reserves into income and hundreds of unsupported journal entries, effectively overstating Cendant's income by 24 percent, and earnings per share by 130 percent.

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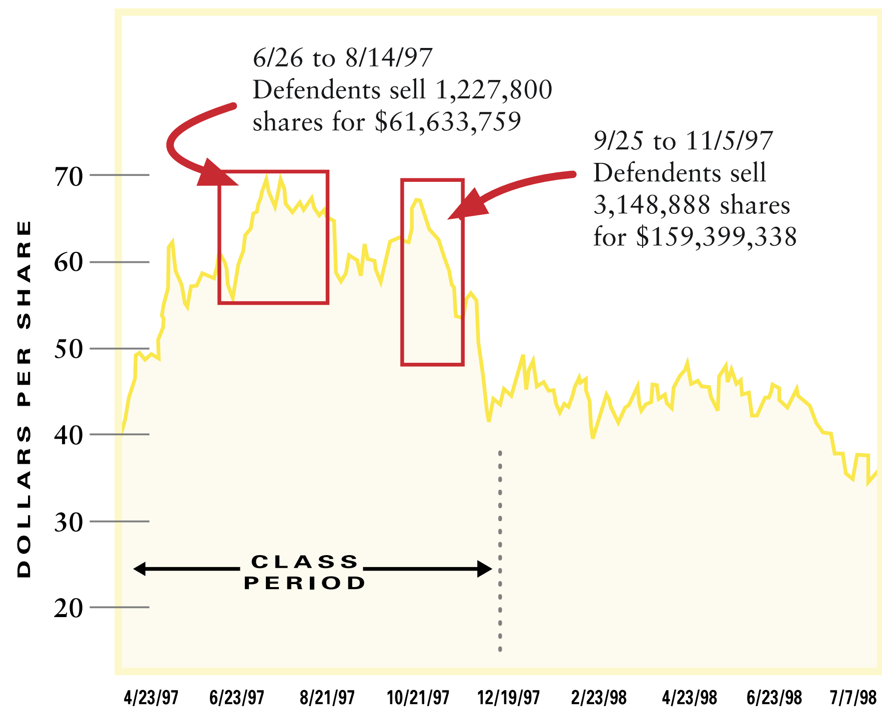
3COM CORPORATION INSIDER SALES

Daily Stock Prices: April 23, 1997 to July 7, 1998



Eye On The Issues

LEGISLATIVE/REGULATORY UPDATES
AND RECENT DECISIONS OF INTEREST

By Rochelle Feder Hansen

SEC Softens Stance on Audit Committees. Notwithstanding Chairman Levitt's statement that the recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees "deserve quick implementation," see Volume 1, Second Quarter page 6 of the *Advocate,* the SEC is considering easing one of the key proposals in response to worries expressed by audit committee members about increased risks of liability. The Committee urged the SEC to establish rules requiring the audit committee to confirm that the committee, "in relying on reviews and talks with management and external auditors, believes that the firm's financial statements conform to Generally Accepted Accounting Principles." Instead, the SEC staff plans to recommend that audit committees certify only that their firm's financial statements reflect what they believe to be "full and fair disclosure of the financial picture." See BNA, *Securities Regulation and Law Report,* Vol. 31, No. 28, p. 953 (July 16, 1999).

SEC Considers Rules For Insider Trading. According to former SEC solicitor Paul Gonson, the SEC is considering issuing rules relating to insider trading. Areas under consideration include: delineating when a duty exists that precludes a person from trading; establishing a rebuttable presumption that inside information was relied upon if possession of insider information exists; establishing a time period after information is disseminated to the public before an insider could trade in the security; and clarifying when selective disclosure to analysts is prohibited. *See* **"Insider Trading: They Know Something *You* Don't" by Ryan D. Poliakoff on page 1 of this issue.**

SIA to SEC: "Aircraft Carrier" Proposal Too Expensive. As reported in Volume 1, First Quarter page 7 of the *Advocate,* the SEC proposed a fundamental restructuring of the regulatory framework for offerings under the Securities Act. A comment letter from the Securities Industry Association ("SIA") described the proposal as "unnecessary" and "detrimental to issuers," stating that the proposal could impose a $4 billion cost on U.S. capital markets. An economic analysis submitted with its comment letter concluded that the various timing delays in the proposal which would impose the substantial cost increases on the capital markets are likely to be borne both by issuers and investors.

Y2K Legislation Signed Into Law. Private Securities Claims Exempt. On July 20, 1999, President Clinton signed into law H.R. 775, the "Y2K Act." Among other things, the Act provides for a waiting period and notification of potential defendants before qualifying suits can be filed; caps punitive damages for small businesses; provides for proportional liability for defendants except in cases involving intentional harm where joint and several liability would apply. Local and state governments are exempt from punitive damages. The legislation increases the threshold for class action suits to be brought or removed to federal court from $1 million to $10 million in claims or have more than 100 plaintiffs. In his signing statement, the President said that the Administration sought changes in the proposed bills to make the Y2K Act balanced and fair. He noted that the Act expressly exempts Y2K actions involving private securities claims arising under the Securities Act of 1933 and other Federal securities laws that do not involve actual or constructive awareness as an element of the claim. Actions by the SEC are also excluded from the definition of "Y2K Action."

The World—and the SEC—Not Yet Ready for Y2K. Rep. John Dingell (D-Mich.), the ranking member of the House Commerce Committee, responding to the SEC's third annual report on Y2K readiness prepared at his request, stated that it "reveals several red flags that merit special attention." Dingell was particular to note that the SEC's "own internal mission-critical systems, including EDGAR...have not been certified as Y2K compliant." He also highlighted the SEC's concern over the lack of progress in the international arena to achieve Y2K readiness (the report stated that "it seems likely that some Year 2000 disruptions will occur in the financial markets") and pointed to the lack of sufficient progress made by transfer agents and investment advisors in addressing Y2K readiness. Because of the concerns raised by the report, Dingell asked the SEC to provide an interim report on October 15. Congressman Dingell's letter to SEC Chairman Levitt can be found at http://www.house.gov/commerce_democrats/press/106ltr43.htm.

On Legislative Horizon: Increased Disclosure by Hedge Funds. Prompted by the 1998 near-collapse of hedge fund Long Term Capital Management L.P. and the $3.6 billion privately funded bail-out, Representative Richard D. Baker (R-La), chairman of the House Banking Subcommittee on Capital Markets, plans to introduce legislation to require hedge funds to provide increased disclosure. The bill will seek increased disclosure to regulators and senior risk managers at key financial intermediaries; and increased disclosure by publicly held companies of their exposure to highly leveraged institutions.

The People's Republic of China Implements First Securities Law. On July 1, 1999, China implemented the country's first unified securities law which centralizes authority under the recently created China Securities Regulatory Commission. The provisions cover brokers, companies and other intermediaries. While this is viewed as a step forward, analysts and economists note that a functioning stock market could be hampered by vague terminology, an inexperienced regulatory body, interference by government, and a corporate culture that accepts corruption.

Appeals Courts Split On "The Requisite State Of Mind" For Pleading Securities Fraud. In a 2-1 decision in *In re Silicon Graphics, Inc Securities Litigation,* No. 97-16204 1999 U.S. App. LEXIS 14955 (9th Cir. July 2, 1999), the Ninth Circuit held that pleading "mere recklessness" or "motive and opportunity" will not satisfy the pleading requirements of the Reform Act. Instead, a plaintiff must plead, a "heightened form of recklessness," setting forth "in great detail, facts that constitute circumstantial evidence of deliberately reckless or conscious misconduct." This decision conflicts with the Second Circuit's decision in *Press v. Chemical Investment Services Corp.,* 166 F.3d 529 (2d Cir. 1999) and the Third Circuit's decision in *In re Advanta Corp. Sec. Litigation,* No. 98-1846 1999 U.S. App. LEXIS 13332 (3d Cir. June 17, 1999), both of which hold that proof of a defendant's recklessness or "motive and opportunity" to commit fraud establishes *scienter* under 10(5). Then there's the Sixth Circuit, in *In re Comshare, Inc. Securities Litigation,* No. 97-2098 199 U.S. App. LEXIS 15068 (6th Cir. July 8, 1999), which also adopted a recklessness standard but restricted the availability of motive and opportunity as a basis from which to infer *scienter.*

PricewaterhouseCoopers Increases Assurance of Auditor Independence. The firm, censured by the SEC earlier this year for violations of rules relating to an auditor's independence, see Volume 1, First Quarter page 6 of the *Advocate,* has announced that it is broadening its prohibitions on investments by its employees and managerial consultants in companies that the firm audits. According to a firm spokesman, the change in policy, which reportedly has been in the works since 1998, would prohibit managers deemed to be working on the audit engagement, or working in an office of the firm carrying out the audit, from having a financial interest in the audit client. The prohibition would also extend to other high-ranking individuals in all sections of the firm that provide "client services." Affected employees, their spouses, dependant children and cohabitants, will be required to withdraw any investments they may have in audit clients, including stocks and bonds along with shares in mutual funds audited by the firm.

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Institutional Activism Briefs

A management proposal at Peerless Systems to add one million shares to an option plan was defeated on June 17, 1999 after the State of Wisconsin Investment Board ("SWIB") lobbied against the proposal by sending a letter to shareholders critical of, among other things, the potential dilution represented by plan. The company resorted to the tactic of "keeping the polls open" on the option plan in the hope of getting shareholders to switch their votes. This was SWIB's third successful opposition to management-sponsored stock option plan proposals this year. See Council of Institutional Investors Alerts, Vol 4, Nos. 2, 25 and 28.

The amicus brief submitted by the Council of Institutional Investors to the Delaware Supreme Court in the appeal of the dismissal of a derivative suit against Walt Disney arguing that the Chancery Court's approach to determining the independence of Disney's directors was flawed appears to have prompted that court's decision to call for an *en banc* hearing of arguments. This could be an indication that the court is reconsidering the issue of how the independence of corporate directors is determined. The hearing is scheduled for September 14, 1999. See Council of Institutional Investors Alerts, Vol. 4, Nos. 25 and 28.

The Teachers Insurance & Annuity Association-College Retirement Equities Fund ("TIAA-CREF"), has continued success in its battle against "dead hand" poison pill proposals. At the July 23, 1999 annual meeting of Mylan Laboratories Inc., TIAA-CREF's resolution requesting the company to redeem or put to a shareholder vote its "dead hand" poison pill won an overwhelming victory receiving support from 67 percent of the shares voted, according to a preliminary count announced by the company. See Volume 1, Second Quarter p.7 of the *Advocate* regarding TIAA-CREF's other efforts.

This year, institutions filed, or threatened to file, 33 binding bylaw resolutions, sponsored more than half of 1999's winning resolutions and successfully led the opposition to several management proposals.

INSIDER TRADING...
THEY KNOW SOMETHING YOU DON'T

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On disclosure of this fraud, the value of Cendant stock dropped 47 percent, causing a total one-day loss of $14.2 billion, the largest one-day drop in U.S. history. After this drop, Cendant repriced the options of many of its executives, including those held by its top officers and non-employee directors, allegedly in an effort to minimize the loss the executives suffered as a result of the fraud. Instead of being worthless, these newly repriced options were nearly as valuable as before the announcement of the fraud.

Institutional investors lost hundreds of millions of dollars as a result of the Cendant fraud. Cendant's corporate insiders, the very same people who closed the merger without performing financial due diligence, fared much better. The complaint alleges that, during the fraudulent scheme, Cendant insiders sold almost 8.2 million shares of Cendant common stock, reaping proceeds of over $287 million. Almost 60 percent of these shares were sold after the merger, with the bulk of that amount sold in the three months immediately preceding Cendant's disclosure of the financial fraud. This profit was in addition to the gains reaped by the repricing of executive stock options. The U.S. District Court for the District of New Jersey recently upheld the class action complaint against the Cendant defendants, at least partly due to the fraudulent intent demonstrated by their egregious actions. For more information on options repricing, see "The Battle Over Options Repricing: Investors Take the Offensive", in the Volume 1, First Quarter 1999 issue of the *Institutional Investor Advocate.*

In the largest and most egregious securities frauds, insider trading often runs rampant. Take, for example, the case of 3Com Corporation, relating to its merger with U.S. Robotics. The complaint alleges that, in the merger prospectus, U.S. Robotics falsely inflated its financial results. At the same time, corporate

> *Insider trading profits often total in the hundreds of millions of dollars, and none of these insiders magnanimously return the profits from their illegal sales of stock.*

insiders at 3Com and U.S. Robotics began to sell off more than $220 million worth of stock. *(See chart on page 5.)* Plaintiffs further allege that, after the merger, 3Com continued to hide the poor performance of its U.S. Robotics products.

In November of 1997, it was finally revealed that U.S. Robotics had stuffed the channels with its products, thereby hiding a $160.3 million dollar loss in two months preceding the merger. Among the corporate insiders, several sold 100 percent of their holdings in 3Com, with certain individuals reaping over $50 million in total proceeds. Again, the U.S. District Court for the Northern District of California upheld the majority of the fraud claims brought against 3Com and its insiders. The court made note of plaintiff's allegations of insider trading, including the fact that seven of the eleven individual defendants sold over 50 percent of their holdings, and that two of the remaining four individual defendants each gained more than $50 million in proceeds.

Profits from insider trading can often total in the hundreds of millions of dollars. None of these insiders magnanimously return the profits from their illegal sales of stock. In a private securities fraud lawsuit, demanding reimbursement of insider profits is one of the most common and successful ways to personally attack those corporate individuals who

"Would you please elaborate on 'then something bad happened'."

Quarterly Quote

"What has sparked Chairman Levitt's war on falsified earnings reports isn't the occasional distracted CEO. It's the continual eruption of accounting frauds. The accumulation of cases, in fact, keeps suggesting that beneath corporate America's uncannily disciplined march of profits during this decade lie great expanses of accounting rot, just waiting to be revealed."

"Lies, Damned Lies, and Managed Earnings,"
Fortune, August 2, 1999

promulgate a fraud. It is therefore in the interest of both private plaintiffs and the SEC to ensure that inside traders are forced to pay for their fraudulent activities. SEC-imposed penalties for insider trading can be extreme, and include disgorgement of all profits, treble damages, and, in egregious cases, jail-time for fraud. Further, the SEC commonly awards bounties of up to 10 percent of the recovered penalty to those informants who provide information leading to the successful prosecution of insider traders.

Consider finally the case against telecommunications company Advanced Fibre, Inc. It is alleged that, in 1997, Advanced Fibre devised a scheme to hide its failing business relationship with its largest customer, GTE. Plaintiffs claim that Advanced Fibre knew that, due to both technological deficiencies in its product and GTE's changing needs, GTE would no longer purchase products from Advanced Fibre. Despite this fact, Plaintiffs claim that Advanced Fibre falsely announced the existence of a new, three-year supply contract with GTE. In reality, this contract is alleged to have been no more than a standard management contract, which did not obligate GTE to purchase any product of any kind from Advanced Fibre.

The complaint alleges that Advanced Fibre executives knew that their stock would drop precipitously once the true nature of the business relationship with GTE was disclosed. As a result, in the months leading up to the ultimate disclosure, Advanced Fibre executives dumped huge percentages of their personal securities holdings.

The complaint further alleges that the company co-founder sold nearly half of his total holdings of common stock, realizing proceeds in excess of $44 million. At the same time, the then-acting CEO of Advanced Fibre sold over 81 percent of his holdings in the company at artificially inflated prices, for proceeds of over $6 million. When the truth was ultimately revealed, Advanced Fibre stock plummeted 52 percent, falling from a share price of $40.26 to $19.125.

How can you, as an institutional investor, determine whether corporate insiders are engaged in covertly fraudulent sales of securities? The 1934 Securities Exchange Act, Section 16(a), provides that every officer or director of a publicly-traded company, as well as the owners of 10 percent or more of any class of security, must file a report of any change in their total holdings within 10 days of the end of the month in which that change occurred. This report is made on a Form 4 and filed with the Securities and Exchange Commission. The Form 4 has become the investor's strongest tool in the fight against illegal profits. As a result of this reporting requirement, information on insider trading is readily available, and can serve as a blueprint of management's knowledge of fraud.

Information on insider trading can be found over the Internet, at little or no cost. The web sites listed here (see box) offer instant access to insider trading reports, and should be a part of any search for information on improper insider sales.

And what should you do if you discover that the officers and directors of your largest investment have dumped half of their personal ownership in a short period? You may want to ask yourself whether, if you were an officer and you thought the company was doing well, would you liquidate your stock? If the answer is no, it is probably time to sell.

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Insider Trading Web Sites

Insider Watch
www.cda.com/investnet/

Insider's Daily
www.newstraders.com/features/insidersdaily.htm

Quicken.com
www.quicken.com/investments/insider/

QuickStart Insider Trading Monitor
www.academic.n2k.com/p/p0549da.htm

Bloomberg's Insider Focus
www.bloomberg.com/fun/bbco.html

AGGREGATION...
Do Too Many Cooks Spoil the Broth?

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In other early cases, however, some courts took the other extreme, rejecting aggregated plaintiffs and opting for a single lead plaintiff. See, for example:

- *In re Donnkenny Inc. Securities Litigation (S.D.N.Y. 1997):* "To allow an aggregation of unrelated plaintiffs to serve as lead plaintiff defeats the purpose of choosing a lead plaintiff."
- *Gluck v. CellStar Corp. (N.D.Tex. 1997):* "Where the interest of one institutional investor in the litigation far exceeds the interests of the other purported plaintiffs, nothing persuades the Court to appoint co-lead plaintiffs."

A review of more recent cases suggests that courts are beginning to stake out positions somewhere between these two extremes, although much closer to the latter view. Concerned that some

Some courts are so antagonistic to aggregation that they even reject proposed "sub-group" alternatives.

proposed lead plaintiff structures may be too complex and therefore ineffective in controlling counsel, courts have been more inclined to reject groups of large number of investors, even when no one else has filed a competing lead plaintiff motion. In *Chill v. Green Tree Financial Corp.* (D. Minn. 1998), for example, the court rejected the appointment of a group of approximately 300 investors on the ground that their appointment "would threaten the interests of the class, would subvert the intent of Congress, and would be too unwieldy to allow for the just, speedy and inexpensive determination of the action." Explaining that a case-by-case "rule of reason" analysis is appropriate, the court instead appointed the six members of the proposed group who had the largest losses as lead plaintiffs.

Fewer Plaintiffs, More Meaningful Control

In this and other cases in which courts have whittled down the number of plaintiffs for the leadership role, the rationale is that the fewer the plaintiffs, the more likely they are to exercise meaningful control of the case. See, for example, *In re Advanced Tissue Sciences Securities Litigation,* (S.D.Cal. 1998), a case where each competing group consisted entirely of hundreds of unrelated individual investors. Noting that neither group contained a pension fund or institutional investor, the court rejected each group and exercised supervisory authority to select a subgroup of six investors offered as an alternative for lead plaintiffs.

The growing reluctance to accept a group of many individual shareholders as a "group of persons" for purposes of the PSLRA was well expressed in a recent opinion issued in the District of Columbia:

- "The mere fact that a proposed lead plaintiff group might have the largest combined financial stake, however, does not guarantee client control. It ordinarily will be the case that such an assemblage will be unable to manage the litigation and control the lawyers." *In re Baan Company Securities Litigation* (D.D.C. 1999). See also:
- *Takeda v. Turbodyne Technologies, Inc.* (D.D.C. 1999) (quoting *Baan* and rejecting competing groups comprised of hundreds of investors, choosing instead to approve an alternative of seven individuals with the largest collective losses).

Concerned that some proposed lead plaintiff structures may be too complex and therefore ineffective in controlling counsel, courts have been more inclined to reject groups of large number of investors, even when no one else has filed a competing lead plaintiff motion.

- *Yousefi v. Lockheed Martin Corp.* (C.D. Cal. 1999) (rejecting a motion to appoint 137 unrelated individuals as lead plaintiffs as counter to the purpose of PSLRA, selecting instead (and on its own initiative) the two shareholders with the largest losses).

Some courts are so antagonistic to aggregation that they even reject proposed "sub-group" alternatives. In *Tumolo v. Cymer, Inc.* (S.D.Cal. 1999), the court rejected an unopposed motion for the approval of a group of 339 investors as lead plaintiffs. While acknowledging that the PSLRA expressly permits appointment of more than one lead plaintiff, the court invoked its discretion to reject motions for appointment of a large assortment of unrelated persons "if that appointment would contravene the letter and spirit of the PSLRA." Concluding that the appointment of such a large group "would make the administration of this action unnecessarily complex and time-consuming" and, moreover, trigger concerns about the degree of control that such a broad and diffuse group could retain over

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Informed Sources

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Q *What are the implications of the Ninth Circuit's decision in Silicon Graphics on claims asserted under the federal securities laws, and what is being done to remedy this decision?*

A As discussed by Rochelle Hansen in her *Eye on the Issues* column, the Ninth Circuit ruled that to establish liability under Section 10(b) and the Private Securities Litigation Reform Act (the "PSLRA") a plaintiff must plead, "in great detail, facts that constitute circumstantial evidence of deliberately reckless or conscious misconduct." Accordingly, a showing of "mere" recklessness no longer suffices in the Ninth Circuit.

There is no question that the *Silicon Graphics* decision makes it significantly more difficult for a plaintiff to plead fraud in a securities case, especially given the fact that under the PSLRA a plaintiff is not afforded any discovery until after a defendant's motion to dismiss is denied by the Court. It is important to note, however, that the *Silicon Graphics* decision is limited to the states that comprise the Ninth Circuit: California, Arizona, Nevada, Washington, Oregon, Idaho and Montana. The Ninth Circuit's decision also directly conflicts with the decisions of the Second, Third and Sixth Circuit Courts of Appeals, which have held that pleading recklessness is sufficient for establishing liability under the PSLRA.

The plaintiffs in *Silicon Graphics* have moved to have the case reheard by the panel of Ninth Circuit judges that decided it or, in the alternative, by all Ninth Circuit judges in what is called an *en banc* hearing. The SEC has submitted an *amicus curiae* brief in support of a rehearing, arguing that the PSLRA did not alter the rule of law for the last twenty years; namely, that recklessness satisfies the state of mind requirement for proving fraud under Section 10(b) and Rule 10b-5. Further, numerous public pension funds as well as the Council of Institutional Investors have taken a proactive role on this front and have submitted letters to the Ninth Circuit in support of the SEC's *amicus curiae* brief.

In the event the panel or the full Ninth Circuit grants plaintiffs' motion for rehearing, the court could, in its discretion, vacate the prior decision pending its new opinion. If however, plaintiffs' motion is denied, then plaintiffs can seek to pursue their appeal in the Supreme Court of the United States. Thus, until we have some further ruling on this issue, the heightened pleading standard set forth in the Silicon Graphics decision will remain the one under which plaintiffs' securities claims will be examined and tested.

Q *Are the costs and expenses incurred by an institution in its capacity as lead plaintiff in a securities class action reimbursable from a recovery by the class?*

A This question, which may be the subject of a future article in the *Advocate,* raises issues on which there is very little law. Nevertheless, the PSLRA specifically provides that while the share of any final judgment or settlement that is awarded to a lead plaintiff shall be equal, on a per share basis, to the portion of the judgment or settlement awarded to other members of the class, this shall not "limit the award of reasonable costs and expenses (including lost wages) directly relating to the representation of the class, to any representative party serving on behalf of a class."

While no institution serving as lead plaintiff has yet to submit its costs and expenses incurred on behalf of representing a class in a securities case prosecuted under the PSLRA, we believe that if proper recordkeeping is maintained for all expenses and costs, including wages paid to personnel for time devoted to the litigation, then those expenses may be submitted to the Court for reimbursement.

AGGREGATION...
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counsel, the court denied the motion. The court also went on to reject an alternative request to appoint a sub-group of seven of the 339 investors as lead plaintiff, citing the absence of proof that this smaller group was any more qualified to serve as lead plaintiff than any of the other 332 proposed lead plaintiffs.

This emerging trend of skepticism toward large groups of proposed lead plaintiffs has been heartily endorsed by the SEC, which makes its distaste for aggregation clear in the many *amicus curiae* briefs it files to assist courts weighing lead plaintiff motions. In its brief submitted in the *Baan* case, for example, the SEC argued that "[c]onstruing the term 'group of persons' in light of the language and purposes of the [PSLRA], a court generally should only approve a group that is small enough to be capable of effectively managing the litigation and the lawyers. The Commission believes that ordinarily this *should be no more than three to five persons,* a number that will facilitate joint decisionmaking and also help to assure that each group member has a sufficiently large stake in the litigation." (Emphasis added.) Of note, the SEC spent a significant part of its brief extolling the virtues of having an institutional investor to serve as lead plaintiff.

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The SEC's preference for institutional investors played a role in a recent case in Virginia where, again, the SEC filed an *amicus curiae* brief regarding competing lead plaintiff motions. In that case, *Switzenbaum v. Orbital Sciences Corp.* (E.D.Va 1999), a group of seven individuals with an aggregate loss of approximately $857,000 competed with five New York City pension funds whose losses totaled approximately $716,000. While acknowledging that the group of seven would be the presumptive lead plaintiffs "[i]f damages alone were the only relevant consideration," the court rejected that group as unable to offer adequate representation to the class. In addition to citing "disorder" within that group's leadership and other shortcomings, the court expressed concern that the group had provided little information about the ties that the seven members had to each other or to the putative class. Referring to the SEC *amicus* brief, the court rejected, and criticized, the group's alternative effort to inflate their aggregated losses by including the losses of approximately 200 other putative class members, "as if to suggest that all of them could manage the case together despite the obvious logistical impossibility of doing so." In contrast, the court observed, the New York pension funds appeared well capable of working together, with the City's office of corporation counsel able to monitor the actions of the pension group and its lead counsel.

Conclusion

In sum, after a period of time in which courts had simply compared total losses and selected lead plaintiffs without much analysis, courts are growing more inclined to look behind the numbers asserted by lead plaintiff candidates and question whether the proposed appointment will advance or hinder the aims of Congress. This trend is almost certain to inure to the benefit of institutions who may find themselves competing with aggregated groups in future securities actions.

Stay tuned!

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