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INSTITUTIONAL INVESTORS AS LEAD PLAINTIFFS: IS THERE A NEW AND CHANGING LANDSCAPE?

By Max W. Berger and Gerald H. Silk

Three years ago, an institutional investor would no more have considered seeking a position as "lead plaintiff" in charge of prosecuting a securities class action lawsuit than it would have predicted that a start-up Internet company such as Yahoo! would be trading at more than $250 per share, or almost 600 times earnings. This all changed, however, in December 1995, when Congress passed, over President Clinton's veto, the Private Securities Litigation Reform Act (the "PSLRA" or "Reform Act") to curb perceived abuses in the securities class action context, and encourage institutional investors, such as public pension funds, to serve as lead plaintiff in these cases.

The PSLRA embodies Congress' intention to facilitate the ability of institutions to be appointed lead plaintiff in shareholder class action lawsuits. In that connection, the PSLRA requires that the court adopt the presumption "that the most adequate plaintiff [to serve as lead plaintiff]...is the person or group of persons that...in the determination of the court, has the largest financial interest in the relief sought by the class," and who otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure. This presumption may be rebutted only by proof that the presumptive plaintiff will not fairly and adequately protect the interests of the class or is subject to unique defenses foreclosing adequate representation.

The Reform Act was intended to eliminate the widespread and well-known "race to the courthouse." Prior to the Reform Act, a lead plaintiff position was typically awarded to the plaintiff who was first to file a complaint. Most of the time, control over the litigation vested in plaintiffs who had very small holdings in the defendant company and were, in turn, controlled by their lawyers who often filed complaints within twenty-four hours of a negative announcement.

In contrast, under the PSLRA, the first plaintiff to file a complaint must publish notice within 20 days of such filing to identify the claims and the class and advise members of the class of their right to move to serve as lead plaintiff in the action within 60 days from the date of publication of the notice. Within 90 days of the publication of notice, the court is required to

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THE BATTLE OVER OPTIONS REPRICING: INVESTORS TAKE THE OFFENSIVE

By Robert S. Gans

Computer magazine publisher Ziff-Davis was hardly an unknown entity when it commenced its initial public offering on April 29, 1998. Sold by Forstmann-Little & Co. to Japanese conglomerate Softbank in 1996, the creator of such widely read periodicals as *PC Magazine* and *Computer Shopper* is the largest technology publisher in the United States in terms of total magazine revenue, accounting for 36.8% of all advertising and circulation dollars spent in computer periodicals.

Given the recent appetite of investors for cyberspace-related entities, it is not surprising

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Inside Look

This is the first issue of the Bernstein Litowitz Berger & Grossmann LLP *Institutional Investor Advocate*, which we intend to publish on a quarterly basis. We hope that the *Advocate* will become an important and useful guide for institutional investors. It is our goal to make the *Advocate* informative and worthwhile reading to help you in managing the exciting and ever-changing world of securities and corporate governance litigation and regulation.

In this issue, in addition to our regular features, you will find articles that explore the changing landscape of securities class action litigation, particularly in light of the lead plaintiff provisions of the Private Securities Litigation Reform Act; the ability of institutional investors to foster social change in the companies in which they invest; and the compelling issue of options repricing.

We hope that the *Advocate* will help you to strengthen your important role as guardians of the financial markets. We welcome your thoughts, suggestions, comments and opinions. Please call, write, or e-mail us and let us know what you think — or even just to request a custom binder to store your copies of the *Advocate*.

Max W. Berger

A LESSON IN INSTITUTIONAL ACTIVISM: THE TEXACO DISCRIMINATION LAWSUIT

By Steven B. Singer

Leo Durocher, the famously pugnacious baseball manager, was once asked by a sportswriter why he remained so combative throughout his entire career. Leo peered up at the scribe who had dared to ask him such a question and sneered in response, "because nice guys finish last." In the world of sports, this behavior is accepted because it is supposedly what you need to do to compete and win. But does Leo Durocher's famous axiom ring true in other fields and endeavors as well? When it comes to matters of corporate governance, the answer is a resounding "no." In fact, when companies do the "right thing," the evidence demonstrates that *everyone* — management, employees and shareholders — ultimately benefits.

A prime example is the class action race discrimination litigation that was brought against Texaco Inc. by its African-American employees in 1994. In that lawsuit, six African-Americans who worked at Texaco facilities across the country came forward to challenge what they claimed were racially discriminatory employment practices and policies utilized by Texaco. The gravamen of plaintiffs' allegations was that Texaco discriminated against African-Americans in terms of promotion and compensation. Simply stated, African-Americans were not promoted at the same rate as similarly qualified Caucasian employees, and African-Americans were not paid the same as their Caucasian counterparts for similar work and responsibilities.

For nearly three full years, the litigation was hotly contested. Texaco denied each and every allegation made by the plaintiffs. Thirty additional Texaco employees — African-American and Caucasian — came forward to attest to discrimination they had either experienced or witnessed while at Texaco. Texaco still denied that there was any problem with its employment practices. After more than one year of intense and hard-fought discovery, plaintiffs moved for class certification. Judge Charles L. Brieant, the Federal judge overseeing the litigation, asked the U.S. Equal Employment Opportunity Commission to conduct an investigation into plaintiffs' class-wide charges of discrimination. Once again, Texaco took the position, now before the EEOC, that African-Americans were not subject to

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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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"appoint as lead plaintiff the member or members of the purported class that the court determines to be the most capable of adequately representing the interests of class members." Finally, "[t]he most adequate plaintiff shall, subject to the approval of the court, select and retain counsel to represent the class."

These changes were intended to allow plaintiffs, such as institutions, to have an opportunity to assess the merits of securities cases more carefully, determine whether to prosecute a particular case and to choose the most adequate and qualified counsel for this task.

The PSLRA's lead plaintiff provisions were intended to vest control of the litigation in the hands of the clients, not the lawyers.

The "race to the courthouse" that the PSLRA intended to eliminate still exists, only now it is in a different form. By securing a single small shareholder plaintiff in a case and publishing notice, either over a news wire service, the Internet or both, the new law has given traditional plaintiffs' law firms the ability to communicate with any number of shareholders. This massive solicitation of plaintiffs, in turn, has given these law firms — the very same firms that Congress sought to "reign in" in the securities litigation arena — the ability to aggregate hundreds of shareholder plaintiffs in an attempt to come up with the largest financial interest in the case and, thus, secure a position as lead plaintiff and, ultimately, lead counsel.

In some cases, this has led to arguably absurd results. For example, in *In re Informix Corp. Securities Litigation,* (N.D. Cal. Oct. 17, 1997), two groups of 979 and 274 aggregated individuals competed for lead plaintiff.

Moreover, some of the PSLRA's fundamental goals have been undermined by this new race to the courthouse. For example, the PSLRA intended that clients seek and choose their counsel, not, as is the case with aggregation, that counsel seek their clients through a massive solicitation campaign. In addition, the PSLRA's lead plaintiff provisions were intended to vest control of the litigation in the hands of the clients, not the lawyers. However, a "group" of unrelated aggregated individuals will have difficulty exercising any degree of meaningful control over their counsel.

Application of the Lead Plaintiff Provisions

Although institutions have not sought lead plaintiff positions in as many cases as Congress hoped, when institutions have moved for lead plaintiff, Congress' preference for institutional investors to serve as lead plaintiffs has been well-recognized by the courts. In numerous cases such as *In re Cendant Corporation Litigation,* (D.N.J. 1998); *Gluck v. Cellstar Corp.* (D. Texas 1997); *D'Hondt v. Digi Int'l Inc.* (D. Minn. 1997), courts have expounded on the fact that Congress passed the PSLRA to increase institutions' participation in shareholder lawsuits for the purpose of preventing lawyer-driven litigation and ensuring that plaintiffs with expertise in the securities markets and with real financial interests in the integrity of the market are in charge of such cases. However, in many of these cases, institutions were faced with significant challenges from other would-be non-institutional lead plaintiffs.

For example, in the *Cendant* case fifteen separate plaintiffs or plaintiff groups sought appointment as lead plaintiff despite the fact that a single group consisting of the California Public Employees' Retirement System, the New York State Common Retirement Fund and the New York City Pension Funds

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(collectively the "Public Pension Fund Group") had the unquestionably largest financial interest in the case, suffering combined losses in excess of $89 million.

Each of the fifteen would-be lead plaintiff groups proffered creative arguments in an attempt to unseat the Public Pension Fund Group and create some leadership position for itself. For example, one argued that the "largest financial interest in the relief sought by the class" should be based upon a proportionality analysis, *i.e.,* an investor who suffered a $1000 loss and who has a net worth of $5000 has a greater financial interest than an institution that may have lost $50 million but has combined assets of $10 billion. Others argued that institutions who still held investments in Cendant could not adequately represent class members who sold their stock after the fraud was disclosed. After a hearing on these motions, however, the Court appointed the Public Pension Fund Group as lead plaintiffs.

In *Gluck v. Cellstar Corp.,* a group of aggregated individuals and entities (the "Group") was competing with the State

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of Wisconsin Investment Board ("SWIB"), the plaintiff with the largest financial interest, for lead plaintiff, or, in the alternative, was seeking appointment as co-lead plaintiff with SWIB. Rejecting the Group's challenge, the court in

> *"Congress did not intend to burden prospective lead plaintiffs with extensive evidentiary proof of typicality or adequacy in a 'PSLRA' designed to reduce the costs of securities class actions and to induce institutional investors to become lead plaintiff."*

Cellstar found that SWIB was well suited to adequately represent the class. The court found that SWIB had the largest financial interest and, as an institutional investor, had experience in acting as a fiduciary and in investment and financial matters that would benefit the class. With respect to the Group's contention that SWIB was not an adequate or typical class representative because of its "sophistication" in financial matters, the court refused to require anything more than a preliminary showing that SWIB satisfied the adequacy and typicality requirements. The court stated: "Congress clearly did not intend to burden prospective lead plaintiffs by requiring extensive evidentiary proof of typicality or adequacy in a 'PSLRA' designed to reduce the costs of securities class actions and to induce institutional investors to become lead plaintiff."

In addition, with respect to the Group's attempt to become co-lead plaintiff with SWIB, the court held that, under the PSLRA's procedures, "where the interest of one institutional investor in the litigation far exceeds the interests of other purported plaintiffs, nothing persuades the Court to appoint co-lead plaintiffs." The court found that appointing co-lead plaintiffs would frustrate "one of the principal goals" of the PSLRA: "to remove 'repeat player' plaintiffs' lawyers from the control of securities litigation and to vest control with large investors." Accordingly, SWIB was appointed lead plaintiff.

Inconsistent Applications

In contrast to *Cendant* and *Cellstar,* some courts have been more responsive to arguments from aggregated shareholder groups seeking appointment as lead plaintiff or co-lead plaintiff with an institutional investor. For example, in *In re Oxford Health Plans, Inc. Securities Litigation,* (S.D.N.Y. 1998), the court appointed the following three *competing* plaintiffs and plaintiff groups as co-lead plaintiffs: (1) the Public Employee's Retirement Association of Colorado (ColPERA), which suffered a loss of $20 million, (2) an aggregated group of individual investors called the "Vogel Group," who suffered a loss of $10 million, and (3) the PBHG Fund, a private institution consisting of growth funds, who had suffered a loss of approximately $3 million.

Declining to appoint ColPERA — the plaintiff with the largest loss of all would-be lead plaintiffs in the case — as sole lead plaintiff, Judge Brieant noted that the language of the PSLRA "expressly contemplates the appointment of more than one lead plaintiff." The court found that the class could benefit from a balanced mix of individuals and institutions and that such a structure "provides the proposed class with the substantial benefits of joint decision-making and joint funding." The court appeared concerned by the fact that counsel for ColPERA had represented to the court that ColPERA would fund the expenses of the Litigation. The court noted that with only one lead plaintiff there could be a greater impetus for settlement if the costs of the litigation increased to an amount greater than affordable. Thus, the court held that "[t]he use of multiple lead plaintiffs will best serve the interests of the proposed class . . . because such a structure will allow for pooling, not only of the knowledge and experience, but also of the resources of the plaintiffs' counsel in order to support what could prove to be a costly and time-consuming Litigation."

> *The SEC stated that "[a]llowing the appointment of multiple plaintiffs would disperse control of the litigation and thus undercut the objective of the [Reform] Act's lead plaintiff provisions."*

The Securities and Exchange Commission ("SEC"), however, has expressed its opposition to the practice of appointing competing would-be lead plaintiffs. In *Oxford,* the SEC submitted an *amicus curiae* brief to the court in support of ColPERA's appointment as lead plaintiff and in opposition to the appointment of competing would-be lead plaintiffs. The

SEC, in arguing that there is no basis or precedent to support the appointment of competing groups of plaintiffs with separate counsel as co-lead plaintiff, stated that "[a]llowing the appointment of multiple plaintiffs would disperse control of the litigation and thus undercut the objective of the [Reform] Act's lead plaintiff provisions."

The inconsistent application of the PSLRA's lead plaintiff provisions has even caused one bizarre and wholly injudicious result. In *Laperriere v. Vesta Insurance Group Inc.* (N.D. Ala. 1998), the Florida State Board of Administration and plaintiff groups consisting of aggregated individuals or entities were competing for appointment as lead plaintiff. The court held that, because it is "unable and/or unwilling to decide between the competing plaintiff groups," it would "do the unprecedented and declare a tie to be resolved by the tossing of a coin." The court also declined to appoint the institution and individual investors as co-lead plaintiffs, finding the approach taken by Judge Brieant in *Oxford* to be "unsatisfactory." In a "separate coin-tossing order," the court provided: "A designee of the Florida Group shall call 'Heads' or 'Tails' while the coin is in the air." Perhaps recognizing the absurdity of its decision, the court's order specifically provided that if either party wished "to file a petition for mandamus seeking to prevent the selection of a lead plaintiff group by this method, the coin toss will be postponed pending a ruling on such petition." As one might expect, the parties reached an agreement to serve as co-lead plaintiffs in the case and no coin was ever tossed.

No one ever would have thought, prior to the passage of the PSLRA, that institutions would be vested with the power and opportunity to control the securities litigation landscape.

Quarterly Quotes

"The motions to designate lead plaintiffs have proven troubling…The court is unable and/or unwilling to decide between the competing plaintiff groups and therefore will do the unprecedented and declare a tie to be resolved by the tossing of a coin…A separate coin-tossing order will be entered."

William M. Acker, Jr., United States District Judge
Laperriere v. Vesta Insurance Group Inc. (N.D. Ala. 1998)

While some cases such as *Oxford* or *Vesta* have resulted in the appointment of an additional or co-lead plaintiff or group of plaintiffs, the ability of the institution to carry out the role that Congress envisioned has not been materially diminished and institutions can still maintain control over the prosecution of these cases. Further, perhaps in recognition of the fact that some courts have been inclined to appoint institutions and aggregated individual groups as co-lead plaintiff, there have been a number of recent cases where institutions have strategically joined with would-be lead plaintiff groups to avoid the unnecessary and costly distraction that a lead plaintiff fight might present.

Conclusion

Just as it would have been difficult for anyone to have predicted the success that a company such as Yahoo! would enjoy in the present stock market, no one ever would have thought, prior to the passage of the PSLRA, that institutions would be vested with the power and opportunity to control the securities litigation landscape, which has, unquestionably, been changed by the lead plaintiff provisions of the PSLRA. How much it has changed remains to be seen, for who knows whether institutional investors' zeal will accelerate or diminish in time or, for that matter, how courts will ultimately rule on the thorny questions surrounding selection of a lead plaintiff where there are competing groups. Stay tuned.

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Eye On The Issues

LEGISLATIVE/REGULATORY UPDATES
AND RECENT DECISIONS OF INTEREST

By Rochelle Feder Hansen

Excellent Settlement Achieved In Action In Which Institutional Investor Came Forward To Serve As Lead Plaintiff. On January 25, 1999, the United States District Court for the Northern District of Texas approved the settlement achieved in a securities class action against Cellstar Corporation. The settlement is one of the first to be presented to the courts for approval in which an institutional investor appointed pursuant to the terms of the PSLRA served as lead plaintiff. The $14.5 million settlement represents a recovery of more than 40% of the claimed damages and includes significant corporate governance changes. The settlement was achieved with the active participation of lead plaintiff State of Wisconsin Investment Board ("SWIB") and has been recognized as an example of what Congress hoped to achieve with the enactment of the PSLRA. **See "Institutional Investors As Lead Plaintiffs: Is There a New and Changing Landscape?" by Max W. Berger and Gerald H. Silk, beginning on page 1 of this issue.**

The Need For Active Participation By Investors Highlighted By Supreme Court's Denial Of Non-Party Shareholders' Right To Appeal District Court Approval Of Derivative Action Settlement. On January 20, 1999, the United States Supreme Court affirmed, by an equally divided Court, the decision of the United States Court of Appeals for the Seventh Circuit holding that shareholders who had not intervened in a derivative action could not appeal approval of the settlement by the District Court. The issue was put before the Supreme Court by the California Public Employees' Retirement System and the Florida Board of Administration. These institutions objected to the settlement in *Felzen v. Andreas,* No. 97-2829, a derivative action against certain of Archer Daniels Midland's officers and directors seeking the recovery of $190 million that the company had paid to settle criminal antitrust charges against it in 1996. The Supreme Court's affirmance of the Seventh Circuit's decision highlights the need, at the outset of the litigation, for institutional investors to become actively involved in shareholder litigation in order to help obtain the best possible result.

Institutional Investor Achieves Major Victory Regarding The Repricing Of Stock Options. In response to letters of inquiry from the State of Wisconsin Investment Board ("SWIB"), the SEC's Division of Corporate Finance staff reversed its prior position and determined that a company may not exclude a shareholder's proposal from proxy materials that calls for a by-law amendment that would require prior shareholder approval for the company to reprice any stock options already issued and outstanding to a lower strike price at any time during the term of the option. The staff stated that the SWIB proposal "deals with a subject matter that is not ordinary business, rather a matter that has become one of the most important corporate governance issues of the day. It is a fundamental right of shareholders to vote on the removal of a potentially huge piece of their equity interest." *General DataComm Indus., Inc.,* [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) 77,481 at 78,473 ((December 9, 1998) **See "The Battle Over Options Repricing: Investors Take the Offensive" by Robert S. Gans, beginning on page 1 of this issue.**

Securities Litigation Uniform Standards Act Becomes Law. On November 3, 1998, Congress passed the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, which makes federal courts the exclusive venue for most securities class actions. The act does not prevent lawsuits brought on behalf of a handful of individuals from being brought in state court; a pension plan, partnership, corporation or the like is counted as a single person, unless formed for the purpose of participating in the action. Class actions brought on behalf of political subdivisions or pension plans for state or local government employees may continue in state court. Derivative actions are not affected by the act and nothing in the act affects enforcement actions brought by state securities commissions or attorneys general.

SEC's Increased Focus on Auditor's Independence Proves Fruitful. The SEC recently censured PricewaterhouseCoopers, the world's largest accounting firm. It had discovered 70 instances in which the firm's partners, employees or pension fund had invested in companies that the firm audits, a violation of the rules relating to an auditor's independence. In settling the complaint with the SEC, PricewaterhouseCoopers agreed to hire an outside consultant to investigate whether there were any additional instances where there was improper ownership of investments in audit clients and to notify the chairman of a company's audit committee if such improper investment was discovered; it must also adopt new procedures and controls; and, it has agreed to pay $2.5 million into a fund that will be used to educate auditors on the independence rules. The regulators have not discovered problems in any of the financial statements of the companies in which the investments were owned.

Second Circuit Court of Appeals Rules Lead Plaintiff Order Not Appealable. A recent ruling of the United States Court of Appeals for the Second Circuit in the *Oxford Health Plans, Inc. Securities Litigation* underscores the importance of having appropriate persons timely move for certification as lead plaintiffs pursuant to the provisions of the PSLRA. On October 15, 1998, in *Metro Services Inc. v. Wiggins,* Docket No. 98-104, the Court held that it lacked subject matter jurisdiction and, therefore, could not hear an appeal from the order of the District Court appointing three competing plaintiff groups as co-lead plaintiffs in the action. ColPERA, the plaintiff with the largest financial interest in the case, and, therefore, presumptively the appropriate lead plaintiff, sought to challenge the district court's appointment of co-lead plaintiffs.

SEC Considering Proposals For Implementing A Fundamental Restructuring Of The Regulatory Framework For Offerings Under The Securities Act. SEC Release No 33-7606A, referred to as the "aircraft carrier" proposal of rule changes and its companion proposal Regulation M-A, seek to implement a fundamental restructuring of the regulatory framework for offerings under the Securities Act. The proposal would utilize three main "forms" — the applicable form would depend on, among other things, the size of the issuer, the type of transaction, and the targeted investor. Form B, which contains the most significant registration modifications, would be used by larger seasoned issuers and for offerings to relatively sophisticated or informed investors. Form B registrants would be subject to limited prospectus disclosure requirements and, though still governed by the antifraud provisions of the Securities Act, they would enjoy greater flexibility in their communications with investors and the market. Mr. Hunt stressed the importance of investor comments on the "aircraft carrier" proposals. **The proposals were published in the Federal Register on December 4, 1998 at 63 FR 67174. Comments are due to the Commission by April 5, 1999.**

SEC Focusing On Increase In Accounting Fraud. SEC Enforcement Director Richard H. Walker has said that his number one priority is combating financial fraud. In a recent address, he noted that accounting fraud, involving hundreds of millions of dollars and occurring in companies where one would not expect to find it, is on the rise. Among other things, Walker noted that he is concerned that members of the accounting profession may have become more complacent in the wake of the Supreme Court's decision in *Central Bank of Denver, N A. v. First Interstate Bank of Denver N.A.,* 511 U.S. 164 (1994), which eliminated a private cause of action for aiding and abetting securities fraud, and the even greater comfort given to accountants with the passage of the PSLRA and the interpretations that have been given to the act by some courts.

In recent months, SEC Chairman Levitt has also focused on the need to remedy widespread problems in corporate accounting and financial reporting. In that regard, Chairman Levitt noted that "earnings management" has increased and could have adverse consequences on the entire financial reporting system. The Commission has undertaken several initiatives to combat this increasing problem, including:

- SEC review and enforcement teams will formally target reviews of public companies that announce restructuring liability reserves, major write-offs or other practices that appear to manage earnings.

- SEC adoption of a rule amendment spelling out when it will censure, suspend or bar accountants for "improper professional conduct."

Compromise Of Auditor's Independence A Cause Of Concern At The SEC. In the wake of the rising concern over compromised independence caused by the billions of dollars that accounting firms pull in from their consulting contracts with audit clients, the Independence Standards Board, which had been asked to address this issue by the SEC, approved rules which require an accounting firm to write a letter to a company's audit committee describing any relationship that could be considered a possible conflict of interest, such as consulting work for the company, employment of former auditors at the company, or any financial interest that the auditors have in the company. The auditor must then explain why the relationships have not affected their objectivity. The new rules apply to audits of companies that have fiscal years ending after July 15, 1999.

Modernization Of The Nation's Finance Laws Will Be A Congressional Focus In 1999. Senator Phil Gramm, the new Chairman of the Senate Banking Committee and an original co-sponsor of both the PSLRA and the Uniform Standards Act, stated that modernization of the nation's finance laws will be an important committee priority. The 105th Congress narrowly failed to pass legislation that would have repealed the anti-affiliation provisions of the Glass-Steagall Act and the Bank Holding Company Act which would have allowed for the merger of banking, insurance and securities organizations under a single holding company structure. In addition to meeting with members of the Committee, Federal Reserve Board Chairman Alan Greenspan and Treasury Secretary Robert Rubin, Senator Gramm plans to meet with representatives of all groups that are potentially affected by financial modernization.

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THE BATTLE OVER OPTIONS REPRICING: INVESTORS TAKE THE OFFENSIVE

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that the investment community responded enthusiastically when Softbank announced the sale of nearly 30% of its stake in the Company to the public at a price of $15.50 per share, in an IPO that would net the Japanese parent approximately $400 million. Soon after the IPO, however, Ziff-Davis' prospects declined dramatically. Between August and October, the Company announced successive quarterly losses and a massive restructuring, causing the stock price to fall below $4 per share merely six months after the offering. As the Company's market capitalization declined by nearly $300 million, investors were left to hope for a substantial rebound.

Officers and directors of the Company found their options suddenly valuable, while purchasers in the IPO were left to wonder if they would ever recover their losses.

Ziff-Davis top management should have shared the risk assumed by shareholders in the face of the stock's precipitous decline. In connection with the IPO, a majority of the Ziff-Davis board of directors, including the Company's CEO, received options to purchase common stock at $16 per share — $0.50 above the public offering price, and reflecting a level that aligned management's interests with public shareholders. Less than five months after the IPO, however, Ziff-Davis reduced the exercise price of all outstanding options, including those awarded to the board, to $6 per share. Thus, as Ziff-Davis stock recovered to $7 per share by October 28, officers and directors of the Company found their options suddenly valuable, while purchasers in the IPO were left to wonder if they would ever recover their losses.

Option repricings such as those at Ziff-Davis have drawn the ire of investors in recent years. Once a relatively isolated practice, some experts now estimate that 10% to 20% of all publicly held companies will have engaged in some form of option repricing by next May. Indeed, *The New York Times* recently reported that, in October alone, more than 100 companies disclosed option repricings in announcements or filings with the SEC.

Silicon Valley executives, where option repricing is most prevalent, vigorously defend the practice as a necessary tool to retain key employees and ensure the long-term health of the corporate enterprise. These executives argue that holders of "underwater" options are prime fodder for competitors, who can attract key employees with promises of option awards exercisable at current market levels. Indeed, this reasoning led more than half a dozen high tech companies to reprice options recently, including Apple Computer, Adaptec, Netscape Communications, Actel, 3Com, Seagate Technology, and Informix Software. Telecommunications network equipment manufacturer Ascend Communications repriced employee options twice within a two-month period during 1997, as the market price of its stock declined from $90 to $23 per share.

Option repricing is not limited, however, to Silicon Valley inhabitants. Retailers Best Buy, Kmart, and Michaels Stores, along with apparel manufacturer Phillips-Van Heusen disclosed option repricings in 1997, among others. Earlier this year, consumer services giant Cendant disclosed perhaps the largest and most pervasive accounting fraud in history within months of its formation through the merger of HFS and CUC. As the price of Cendant common stock plummeted, the Company responded by repricing employee options, including those held by top officers and non-employee directors, while shareholders who were victimized by the fraud lost billions of dollars.

As the price of Cendant common stock plummeted, the Company responded by repricing employee options, including those held by top officers and non-employee directors, while shareholders who were victimized by the fraud lost billions of dollars.

Institutional investors and their advisors have roundly criticized the practice of option repricing, arguing that it not only causes substantial dilution in the case of volatile stocks such as Ascend, but that it also is generally ineffective in reversing a company's prospects. For example, Patrick McGurn and Howard Sherman of Institutional Shareholder Services, a consulting service that advises institutional investors with respect to proxy voting and corporate governance issues, note in the November 16 issue of *Pensions & Investments* that Apple Computer suffered disappointing performance for years despite multiple rounds of option repricing: "True recovery came only after the surgical removal of the company's board and management."

Nevertheless, most experts recognize that, when properly used, employee stock options are a powerful tool to retain and attract key employees, and to rejuvenate laggard performers. For example, when Louis Gerstner became chairman of IBM in 1993, one of his first actions to reverse Big Blue's disappointing performance was to offer repriced options to 1200 managers within the company. Rather than simply reprice all existing options, however, IBM permitted the managers to exchange underwater options for repriced options at a ratio of 2.5 to 1, thereby limiting the dilutive effects of the repricing to public shareholders, while still creating an incentive for key employees. Other companies, including Cendant, LAI Ward Howell, and Reebok, also required employees to accept reduced quantities of options to participate in repricings.

McGurn applauds limitations such as "value for value" swaps, in which employees are required to relinquish options to reflect the cost of the repricing event, and has proposed other reforms in the December 1998 issue of the *Bank and Corporate Governance Law Reporter* to limit repricing abuses. Among other things, McGurn suggests that the exercise price of newly issued options be set at premium levels above the current market price of the stock, to encourage improved corporate performance. McGurn also proposes that companies set "blackout" periods of 12 months or longer before newly issued options may be exercised, or that they reset the vesting schedule for newly issued options.

Some defenders of option repricing have suggested that corporate executives should not be penalized by general downturns in the market that depress the value of the company's stock despite strong financial performance. In response to this concern, Professor Ron Gilson of Columbia University has suggested indexing option exercise prices to account for general market trends. Through indexing, corporations would ensure that option recipients are rewarded for benefits to the company, and are not unfairly penalized for general market trends.

At a minimum, however, critics agree that companies should not be permitted to reprice options without obtaining shareholder approval of such transactions. Under the current law, companies need not disclose option repricings in their annual proxy statements unless the repricing includes options to executives named in the proxy. Regulators have resisted the efforts of institutional investors to press for broader corporate disclosure of option repricings, or for provisions requiring shareholder approval of such transactions. For example, the State of Wisconsin Investment Board tried unsuccessfully during 1997 to place a resolution on the proxy of Shiva Corporation, a large telecommunications concern, requiring shareholder approval of any repricing proposals. Agreeing with the Company's decision to exclude SWIB's proposal, the SEC Staff determined that option repricings constitute "ordinary business matters" that need not be submitted for shareholder approval. Similarly, the New York Stock Exchange recently proposed an amendment to the listing requirements that would allow issuers to limit further the disclosure of option repricing plans to shareholders.

The willingness of significant investors such as institutions to challenge management judgements on corporate governance issues such as option repricing is likely to result in stronger, healthier companies that are more responsive to the interest of their shareholders.

Nevertheless, the tide may be turning in favor of shareholder advocates in the debate over option repricing plans. On December 9, the SEC Staff effectively reversed its decision in *Shiva* by requiring General DataComm Industries to include in its proxy a proposal submitted by SWIB requiring shareholder approval of any option repricing plan. The SEC Staff determined that issuers may no longer rely on the "ordinary business" exclusion provided by Rule 14a-8(1)(7) to omit such shareholder proposals from their proxies "in view of the widespread public debate concerning option repricing and the increasing recognition that this issue raises significant policy issues." The Financial Accounting Standards Board also has jumped into the fray, having proposed a new accounting rule that would end favorable accounting treatment for option repricings by requiring companies to record the difference between the exercise price of the option and any rise in the market price of the stock as an ordinary expense on its income statement. (Ironically, FASB encouraged a rash of option repricing by making its proposal effective December 15, 1998 if adopted, creating an incentive for companies to reprice options prior to the effective date to preserve favorable accounting treatment.)

Under the proper circumstances, shareholders also can mount significant legal challenges to option repricing plans. Historically, Delaware courts have not been receptive to shareholder challenges to executive compensation

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A LESSON IN INSTITUTIONAL ACTIVISM: THE TEXACO DISCRIMINATION LAWSUIT

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any discrimination. As plaintiffs had, the EEOC determined that Texaco's performance appraisal process — the system which it used to evaluate all of its employees nationwide — had a "disparate impact" on African-Americans who, as a group, did not receive the high ratings that Caucasian employees did. The EEOC determined that there was "reasonable cause" to believe that Texaco had discriminated against African-Americans "on a class-wide basis," and issued plaintiffs a "right to sue" notice in connection with their class-wide allegations. Nevertheless, Texaco still refused to acknowledge that plaintiffs' case had any merit, instead arguing that the EEOC had considered the wrong evidence and was simply incorrect.

Within two days after the story broke, Texaco stock had dropped more than $5 per share — a loss which, as numerous financial publications noted, wiped out more than $1 billion in market value.

Plaintiffs, meanwhile, had obtained further compelling evidence that supported their claims — audiotapes made by a former Texaco employee on which senior Texaco officers could be heard making disparaging remarks about Texaco's African-American employees and discussing the withholding and destruction of documents which plaintiffs had requested and sought during discovery. When the "Texaco Tapes" surfaced in early November 1996, a national furor erupted immediately. The litigation, which had languished in relative obscurity for the previous three years, suddenly became the biggest story in the country. The Texaco case became a national referendum on employment discrimination. The tapes were played before a national audience on "NightLine." The United States Attorney commenced a criminal investigation and eventually indicted certain Texaco employees on charges of obstruction of justice. Civil rights organizations called for a nationwide boycott of Texaco gasoline.

Significantly, the reports about the tapes and the litigation had a dramatic impact on the price of Texaco stock. Within two days after the story broke, Texaco stock had dropped more than $5 per share — a loss which, as numerous financial publications noted, wiped out more than $1 billion in market value. With institutional investors owning a significant percentage of Texaco stock, the financial and social implications of the tapes galvanized a number of the country's largest institutional investors. At the forefront was H. Carl McCall, the New York State Comptroller and Trustee of the New York State Common Retirement Fund, which at the time owned more than 1.2 million shares of Texaco common stock, with an estimated value of $114 million. Shortly after the story broke, Mr. McCall wrote a letter to Peter I. Bijur, Texaco's new Chairman and Chief Executive Officer, stating that he was "profoundly dismayed" by the reports and correctly noting that the attitudes evinced by these employees were not only "grossly offensive," but had "put shareholders at risk." Mr. McCall called on Mr. Bijur to condemn the remarks and urged him to "take steps to strengthen Texaco's commitment to tolerance and inclusion in the workplace."

Other institutional investors quickly followed suit. New York City Comptroller Alan Hevesi also called upon Texaco to address the situation. State lawmakers in Texas introduced legislation requiring public employee retirement funds to sell their $250 million in Texaco holdings. The City of Philadelphia's public pension funds actually did vote to divest. Numerous other large pension funds and institutions — both public and private — called upon Texaco's Board of Directors to take action.

Within weeks of the initial disclosures about the tapes, Texaco agreed to settle the litigation for $176 million — the largest settlement of a race discrimination case in history. Equally important, the settlement resulted in the creation of an unprecedented "Equality and Fairness Task Force," an independent body comprised of civic, business and civil rights leaders, which was charged with evaluating and improving Texaco's employment systems and practices, and ensuring that Texaco became a bastion for equal opportunity. Contrary to what old Leo Durocher preached, the actions that Texaco took after the tapes surfaced

H. Carl McCall, the New York State Comptroller and Trustee of the New York State Common Retirement Fund, wrote to urge Texaco to "take steps to strengthen its commitment to tolerance and inclusion in the workplace."

has benefitted everyone, including the Company and its shareholders. Within days after the settlement was announced, Texaco stock rebounded to close higher than the price it had been trading at immediately prior to the tapes. Texaco has since implemented a company-wide mentoring program for its employees, revised its performance appraisal process, created an ombudsman program designed to address employee grievances, and made managers' bonuses dependent upon their EEO and diversity compliance efforts. The end result of these dramatic efforts: in 1997, 25% of promotions were earned by minorities, nearly 39% of all new hires were minorities, and Texaco spent more than $400 million with minority- and women-owned business enterprises. In December 1998, Texaco named Deval L. Patrick, an African-American appointed by the Court to serve as the Chair of the Task Force and the former chief of the Civil Rights Division of the Department of Justice under President Clinton, to be its General Counsel.

Obviously, the changes at Texaco occurred in large part because institutions and other large investors — those with the greatest stake and largest financial interest in the company —

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Informed Sources

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Q Why should an institutional investor pursue lead plaintiff status in a class action litigation when it is possible instead to opt out of the class and pursue an individual action for the same underlying claims?

A Lead plaintiff status provides the institutional investor with numerous advantages and opportunities otherwise unavailable to those that opt out of the class to pursue identical claims on an individual basis.

As lead plaintiff, the institutional investor is uniquely positioned to influence and oversee the development of the litigation more effectively than any other plaintiff. First, the lead plaintiff may choose which law firm it wants to represent the class. Thus, the institutional investor will be able to select firms of the highest caliber with proven records of successfully prosecuting complex class action litigations. Second, the institutional investor, as lead plaintiff, serves as the guardian of class interests and, by exerting its leverage, can curb dramatically any possible abuses of the litigation process. The likely result is maximized recovery for the class. Indeed, the PSLRA encourages institutional investors to seek lead plaintiff status precisely for these reasons.

Financially, the institutional investor is better served by seeking lead plaintiff status than by opting out to pursue identical claims on an individual basis. The latter alternative most likely will require the institutional investor to retain counsel on an hourly basis or by partial advancement of attorneys' fees and expenses. In contrast, all costs of prosecuting the class action litigation are typically advanced by plaintiffs' counsel, and any recovery of attorneys' fees and expenses is contingent on the successful recovery for the class.

By pro-actively leading the fight for the collective protection of investors' rights, the institutional investor as lead plaintiff sends a powerful message to public companies that it will not tolerate shareholder fraud. The potential result of this is twofold: (1) clients will feel greater confidence in the security of their investments; and (2) companies in which the institutional investor invests may be less likely to commit fraud in the future. Unfortunately, this message could be lost if an institutional investor decides to opt out of the class.

Q Are all public companies now required to make Year 2000 disclosures?

A Yes, in most circumstances. According to the Securities and Exchange Commission's Interpretive Release of Staff Legal Bulletin No. 5, which became effective August 4, 1998, appropriate Year 2000 disclosures are required in the annual reports of companies with a fiscal year on or after June 30, 1998, and in quarterly reports commencing with quarters ending after August 4, 1998. A company must provide Year 2000 disclosure if: (1) it has not completed its assessment of Year 2000 readiness; or (2) management concludes that the consequences of Year 2000 related systems failures will have a material adverse impact on its business, without taking into account the company's efforts to avoid those consequences. The Securities and Exchange Commission believes that most public companies will fall under one of these two categories and therefore should be providing Year 2000 disclosures. Keep a watch out for these disclosures as they may be quite material to your investment.

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spoke up and urged Texaco to do the "right thing." Indeed, Texaco is a lesson in what shareholder activism can help to accomplish, and how that activism can translate into results that benefit everyone. In fact, one can argue that when difficulties arise at a company, it is incumbent upon institutions to ensure that the problems are addressed and that solutions are found — either through shareholder resolutions, putting pressure on directors and management, or through litigation. The Texaco case certainly proved that to be true.

As for Leo Durocher, well, in 24 years of managing four different teams, he won exactly one World Series.

Within days after the settlement, Texaco stock rebounded to close higher than its trading price immediately prior to the tapes.

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THE BATTLE OVER OPTIONS REPRICING: INVESTORS TAKE THE OFFENSIVE

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where the parties awarding the compensation are disinterested in the transaction. As noted by former Delaware Chancellor Allen in the case of *Steiner v. Meyerson* (1995), the reluctance to entertain challenges to such transactions "reflects the law's understanding of what rules will help promote wealth creating activity. If courts were permitted more freely to 'second guess' the terms of corporate contracts . . . there would be a substantial disincentive created for officers and directors . . . to approve risky transactions."

However, courts are much more likely to entertain challenges to transactions in which a conflict of interest exists, giving rise to a potential breach of fiduciary duty. Under Delaware law, self-interested transactions, such as option repricings that directly benefit the directors who authorized the repricing, present a potential breach of the duty of loyalty that corporate directors owe the company's shareholders. Where a breach of fiduciary duty is adequately pled, the burden of proof rests with defendants to establish the "entire fairness" of the challenged transaction.

Shareholders of Ziff-Davis are currently using this theory of liability to challenge the company's recent option repricing. In their lawsuit currently pending in Delaware Chancery Court, plaintiffs contend that the repricing constitutes a self-interested transaction that increased the compensation provided to Ziff-Davis' top officers and directors by tens of millions of dollars, to the detriment of the Company and its shareholders. Plaintiffs are seeking to enjoin defendants from exercising any repriced options. To the extent any repriced options already have been exercised, plaintiffs are seeking the return of the proceeds of these transactions to the corporation.

All publicly held corporations exist for the benefit of their shareholders, and the directors of these corporations are duty-bound to maximize shareholder value. The current dispute over the propriety of option repricing plans may signify a defining moment in the growing tension between significant shareholders and the management of large, publicly held companies. The willingness of significant investors such as institutions to challenge management judgments on corporate governance issues such as option repricing is likely to result in stronger, healthier companies that are more responsive to the interests of their shareholders.

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