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AN END TO MICKEY MOUSE CORPORATE GOVERNANCE

Institutional Investors Lead the Way

by Robert S. Gans

The Walt Disney Company has long prided itself on making children's dreams come true, but it probably never imagined the nightmare that would ensue from its hiring of Hollywood "super agent" Michael Ovitz as president of the Company and likely successor to CEO Michael Eisner.

Disney touted its signing of Ovitz as a major coup that answered lingering questions over the line of succession at the Company since the untimely death of former President Frank Wells. Scant attention was paid to Ovitz's lucrative severance package in the event that the Company terminated his employment prior to the expiration of his contract. After all, Disney had signed Ovitz to a relatively short-term, five-year contract. Who imagined that Ovitz would not last five years?

The oversight proved costly one year later, when Disney terminated Ovitz's employment with the Company. Indeed, the surprise of seeing Ovitz fired only fourteen months after being named heir apparent was surpassed only by the unprecedented severance package he received pursuant to the terms of his employment agreement: $39 million in cash and over $100 million in fully vested, immediately exercisable stock options. Shortly after this disaster, highly regarded executive compensation expert Graef Crystal described the amount of severance paid to Ovitz as "shocking." Unfortunately, Crystal failed to share these views with the Disney Board one year earlier, when it hired him to render advice on the terms of the Ovitz contract.

Predictably, a number of shareholder lawsuits were filed in the aftermath of the debacle, charging the Disney board with breaching its fiduciary duties to the Company's shareholders by approving a contract that rewarded Ovitz with $140 million for fourteen months of unsatisfactory work. Breach of fiduciary duty cases, however, are not governed by the Private Securities Litigation Reform Act of 1995 (the "Reform Act"), which encourages courts to appoint institutional investors as lead plaintiffs in securities fraud class actions to supervise the litigation and retain highly qualified counsel to represent the Class. Instead, the organization of these cases is still largely governed by the much maligned "race to the courthouse," in which courts generally do not even designate a lead plaintiff, and being appointed lead counsel is the reward for being the first law firm to file a complaint, usually within hours of public disclosure of the challenged event and on behalf of a nominal shareholder with virtually no interest in the litigation. Without the notice provisions of the Reform Act, institutional investors may not even learn about the possibility of bringing a claim until weeks after complaints have been filed, the actions have been organized, and lead counsel has been appointed.

Although the leadership of an institutional investor over shareholder litigation cannot guarantee a favorable result, the absence of such leadership certainly did not help Disney shareholders. The Delaware Supreme Court

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Inside Look

In our effort to keep you, our institutional readers, abreast of developments in the areas of securities and corporate law that directly affect your investments, this issue of the *Institutional Investor Advocate* explores recent institutional investor activism in the field of corporate governance, the importance to our financial markets of the auditing function, and the growing concern over auditor conflicts of interest.

In *An End To Mickey Mouse Corporate Governance: Institutional Investors Lead the Way*, Bob Gans addresses institutional investors' recent forays into the shareholder litigation arena, and the benefits that have resulted from their increased involvement. Dan Berger, in *Corporate Auditors Under Siege*, details the threat to the integrity of our financial markers arising from recently disclosed compromises of auditor independence.

The *Eye On The Issues* section, written by Steve Singer, continues to strive to provide you with legislative and regulatory updates as well as recent decisions of interest. Steve even reports on a sad occurrence involving "life imitating art" and the hit HBO series *The Sopranos*. And, Jeff Leibell answers one of your questions — what remedy does an institutional investor have when a company's response to a shareholder proposal included in a company's proxy is misleading or mischaracterizes the proposal? Finally, Rochelle Hansen and I report on a late-breaking California decision in *Court Prohibits Misleading Soliciation of Class Members*.

As always, we welcome any suggestions you might have on topics for upcoming articles or questions you would like to have explored and answered.

Max W. Berger

ENDING MICKEY MOUSE CORPORATE GOVERNANCE

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noted that "the sheer size of the payout to Ovitz . . . pushes the envelope of judicial respect for the business judgment of directors in making compensation decisions." Nevertheless, in a startling rebuke to the plaintiffs' attorneys, the Court held that "the Complaint is so inartfully drafted that it was properly dismissed under our pleading standards . . ." Indeed, the Court described plaintiffs' 88-page complaint as "a pastiche of prolix invective . . . permeated with conclusory allegations of the pleader and quotations from the media, mostly of an editorial nature (even including a cartoon) . . . Accordingly, they serve no purpose other than to complicate the work of reviewing courts."

The *Disney* case is a cautionary tale in the dangers of institutional investors remaining on the sidelines while significant litigation is entrusted to nominal shareholders lacking the experience or expertise to provide effective oversight. The law of most states generally imposes two overriding fiduciary duties on corporate directors when engaging in any business transaction. First, directors must act as loyal servants of the corporation, and may not seek to profit at the expense of the company and its shareholders. As the Delaware Supreme Court stated years ago in its seminal opinion in *Singer v. Magnavox,* the duty of loyalty "requires an undivided and unselfish loyalty to the corporation [and] demands that there shall be no conflict between duty and self-interest." Second, directors must exercise due care in recommending or approving any business transaction. According to the Delaware Supreme Court in the landmark *Paramount Communications v. QVC Network* decision, the duty of care requires directors to "inform themselves, prior to making a business decision, of all material information reasonably available to them."

The surprise of seeing Ovitz fired only fourteen months after being named heir apparent was surpassed only by the unprecedented severance package he received pursuant to the terms of his employment agreement.

Pitted against these fiduciary duties, however, is the desire to allow directors the freedom to manage the affairs of the corporation on behalf of the shareholders who elected them, without fearing multiple lawsuits initiated by isolated dissidents challenging routine business decisions. Courts generally resolve this conflict by presuming that the directors acted in good faith and on an informed basis when taking action with respect to any business transaction. Nevertheless, where it appears that the directors may have acted in their own self-interest and to the detriment of the shareholders, the Court will apply "enhanced scrutiny" to the board's actions, to ensure that the transaction is fair to the public shareholders of the Company. Such transactions include corporate takeovers, where insiders receive substantial monetary benefits that are denied to the public shareholders, or where an entrenched management rebuffs an offer for the Company based upon a desire to maintain their own employment, rather than safeguard the best interests of the shareholders. Courts also will make a closer examination where there is evidence that the directors failed to inform themselves with respect to the specifics

The Disney litigation shows the dangers of institutional investors remaining on the sidelines while significant litigation is entrusted to nominal shareholders lacking the experience or expertise to provide effective oversight.

of the transaction, or that the transaction, like the payment of $140 million to Michael Ovitz, constitutes a waste of corporate assets. The standard for establishing waste where there is no apparent conflict of interest, however, is exacting, as Delaware Chief Justice Veasey noted in the *Disney* case: "Roughly, a waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade . . . Such a transfer is in effect a gift."

The demanding requirements for bringing a claim alleging a breach of fiduciary duty or corporate waste are evident in the dismissal of the *Disney* action, which the Court itself acknowledged to be "a very troubling case on the merits." In other recent cases, however, institutional investors have borrowed from the lead plaintiff mandate of the Reform Act to assert their considerable weight in the corporate governance arena, often securing better results for shareholders. Institutional investors and substantial shareholders possess knowledge and expertise that simply cannot be matched by a nominal shareholder dominated by his attorneys. By virtue of their substantial investments, institutional shareholders are often highly familiar with the directors accused of engaging in improper conduct, and provide a sense of credibility and urgency that the litigation might otherwise lack. Institutional investors can also play an important policing function in this arena, ensuring that meritorious breach of fiduciary duty claims are resolved in the best interests of the Company and its shareholders, rather than in a manner that does little more than ensure a large fee for the attorneys involved.

Consider the case of Warner-Lambert, the $10 billion consumer products giant with products ranging from Listerine Mouthwash and Trident Gum to Lipitor, the most successful cholesterol-reducing drug in history. Last Fall, Warner-Lambert repeatedly rebuffed acquisition offers from Pfizer, refusing even to negotiate with the pharmaceutical behemoth. Then, in November 1999, Warner-Lambert suddenly agreed to enter into a "merger of equals" with American Home Products, famous for its embattled diet drug Fen-Phen, in a stock-swap valued at $72 billion. Hours later, Pfizer responded with an offer to purchase Warner-Lambert for $10 billion more than AHP, yet the Warner-Lambert board still refused to open negotiations with Pfizer. Significantly, the merger agreement with AHP provided for the Chairman of the Board of Warner-Lambert, who held relatively little of the Company's stock, to head the combined entity, an incentive that had been lacking in the Pfizer offer. Also, the merger agreement prevented Warner-Lambert from entertaining competing proposals, and further provided for the Company to pay a termination fee of $2 billion to AHP if the transaction were not consummated.

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Although dozens of shareholder lawsuits were filed in the hours following the announcement of the Warner-Lambert merger, it was the Company's institutional investors that played a significant role in safeguarding the interests of the public stockholders. After the initial rush of shareholder lawsuits, two Louisiana public pension funds holding approximately $10 million in Warner-Lambert common stock commenced a class action in the Delaware Chancery Court charging the directors of the Company with breaches of fiduciary duty by failing to investigate the Pfizer offer. The Louisiana funds served as lead plaintiffs in the Action, and pressed their claims on an expedited basis to compel Warner-Lambert to at least educate itself as to the Pfizer offer. Shortly thereafter, a group of institutional investors led by CalPERS and the New York City Public Pension Funds publicly implored the Warner-Lambert Board to open negotiations with Pfizer. In the face of this shareholder revolt, the Board's resolve to pursue the AHP transaction crumbled. In early February, Warner-Lambert announced that it would be acquired by

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CORPORATE AUDITORS UNDER SIEGE

Principally authored by Daniel L. Berger

In the depths of the greatest financial disaster to ever hit this country, sixty-six years ago Congress passed the federal securities laws in an effort to rebuild investor trust and confidence in the integrity of the financial market. Trust and integrity are the cornerstones of an efficient financial marketplace, and nothing is supposed to safeguard the market's integrity like an independent accountant's audit of corporate financial statements. This is true because the independent auditor assumes a public responsibility transcending any employment with the corporate client. The independent auditor's ultimate responsibility is to the corporation's creditors and stockholders, as well as to the investing public. Simply put, if investors cannot trust the auditors to police corporate management, they cannot trust the financial data on which billions of buy and sell decisions are based each day.

This "public watchdog" function demands that the auditor maintain total independence from the client at all times to ensure objective, truthful reporting and complete fidelity to the public trust. The importance of this independence requirement was well summarized by the Supreme Court of the United States in *United States v. Arthur Young & Co.*, sixteen years ago when it stated, "Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional . . . . If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost."

Accordingly, it is not enough that the audit quality is maintained and that the numbers are accurate, it is also critical that public investors—the users of corporate financial reports—know that the auditors are acting objectively and independently in their role as the public's financial cop. The American Institute of Certified Public Accountants Code of Professional Conduct describes the principle of "objectivity and independence" by mandating that: "a member should maintain objectivity and be free of conflicts of interest." The application of this common-sense idea could not be simpler: Independent auditors who are engaged to judge the fairness of management's financial statements should avoid all conflicts of interest that would impair their judgment or create the appearance of an impairment.

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Indeed, these independence requirements are particularly critical today as public pension funds, as well as individual investors, are fueling the bull market by investing a healthy portion of their portfolio in the securities market. This huge increase in investment activity in securities, so crucial to our national prosperity, only intensifies the basis for the core values of the independent auditor objectivity and independence, honesty and integrity, commitment to quality and professional expertise in the preparation of corporate financial statements.

Independent Auditors Under Fire

At the same time auditor independence requirements are becoming increasingly crucial, the auditing profession has come under fire as a recent Securities and Exchange Commission ("SEC") report cited more than 8,000 violations by PriceWaterhouseCoopers ("PWC"), the world's largest accounting firm, of one of the basic rules of ethics of audit firms: You don't hold investments in a company audited by your firm. The SEC report estimated that eighty-six percent of PWC's 2,700 audit partners had at least one ethical violation. Among the more serious violations, PWC's accountants owned stock in companies audited by the firm, took out loans from clients audited by the firm, had spouses or other relatives who worked for a client, and managed family trusts that held investments in a client. In a letter to his partners, PWC's Chairman, Nicholas G. Moore and Chief Executive James J. Schiro, called the SEC's investigation's findings "embarrassing to our firm and to all of us as partners." SEC Chief Accountant Lynn Turner called the SEC's report "a sobering reminder that accounting professionals need to renew their commitment to the fundamental principle of auditor independence." At the SEC's request, the Public Oversight Board, an agency created by Congress to keep watch on auditors, will now examine the accounting practices of ten accounting firms, including major auditing firms such as Ernst & Young, KPMG

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Peat Marwick, Deloitte & Touche and Arthur Anderson.

In recent times, however, corporate auditors have been guilty of more than just violating fundamental conflict-of-interest rules, they have been at the center of nearly every recent financial scandal. Judge Friendly of the Second Circuit in *United States v. Benjamin,* noted three decades ago: "In our complex society the accountant's certificate . . . can be an instrument for inflicting pecuniary loss more potent than the chisel or the crowbar." Judge Friendly's words have been borne out, as independent auditors have been held responsible for the outright manipulation and inflation of public companies' earnings to boost stock prices, despite the auditing firms' claims that they departed too early, arrived too late, or for some other reasons were not knowledgeable about the huge financial frauds that have recently rocked our nation's securities market. For example, in *In re Waste Management Securities Litigation,* Arthur Anderson paid $70 million; in *Cendant,* Ernst & Young paid $355 million; and in *Informix* Ernst & Young paid $32 million all to resolve securities fraud actions where there were egregious irregularities with the financial statements of these publicly traded companies and the auditors were at the epicenter of the financial fraud. As United States District Court Judge Stanley Sporken, the former enforcement chief of the SEC, aptly questioned in presiding over the litigation concerning the *Lincoln Savings* financial collapse: "Where were these professionals . . . [referring to the auditors] when these clearly improper transactions were being consummated? Why didn't any of them speak up or disassociate themselves from the transaction?"

While owning stock in a client is an obvious example of why a corporate auditor would refuse to "speak up," it also provides an example of part of a larger problem: the fundamental principle of total independence has been severely jeopardized as accounting firms in recent years have become multi-dimensional professional service conglomerates.

The Metamorphosis of The Auditing Profession:
The Watchdogs Become the Puppies of Management

In the 1970s, accounting firms like Ernst & Young and PWC functioned largely as independent auditors. Business consulting was merely an offshoot of traditional accounting and auditing—a way to derive more income from the same base of clients. But the consulting business took off beginning in the mid-1980s, when consultants from large auditing firms won over the trust of corporate chief financial officers and landed huge technology consulting projects. Today, corporate accounting firms view auditing as a low-profit, low-growth service of diminishing importance, and have instead focused their resources on the more profitable and faster growing non-audit services, including business consulting, tax consulting, human

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Quarterly Quote

"Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional. . . If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost."

Supreme Court of the United States
in *United States v. Arthur Young & Co.* (1984)

Eye On The Issues

LEGISLATIVE/REGULATORY UPDATES AND RECENT DECISIONS OF INTEREST

By Steven B. Singer

Big Six Accounting Firm Faces Fallout From SEC Report Regarding Auditor Independence

The SEC in late February notified 52 companies audited by PriceWaterhouseCoopers that conflicts of interest stemming from firm employees' personal investments in the companies could affect the integrity of their financial statements. The action came on the heels of an SEC report in January that was harshly critical of PWC's adherence to federal rules requiring strict independence of auditing clients. The latest SEC action relates specifically to cases in which PWC auditors and employees owned stock in the very clients the firm was auditing at the same time they were directly providing services to the companies. The SEC recommended that some of the companies replace PWC as auditor of their year 2000 financial statements. *The Wall Street Journal, February 28, 2000.* **See also "Auditors Under Siege," by Daniel L. Berger.**

And The SEC Continues To Crack Down

In the wake of the SEC's investigation of PriceWaterhouse-Coopers that uncovered more than 8,000 separate violations of auditor independence rules, the SEC has directed the accounting industry's watchdog, the Public Oversight Board, to investigate seven other major accounting firms for similar violations. The Big Five firms are being required to invest in computer systems that will allow them for the first time to track employees' investments in order to guard against conflicts of interest, and to consider separating their auditing and consulting businesses. The bulk of the infractions committed by PWC broke accounting's most fundamental rule: that partners may not own stock in companies audited by their firm (the SEC found that half of PWC's partners owned stock in companies PWC audits). The reason the SEC wants these changes is simple; auditors may hesitate to issue tough opinions on companies' financial statements when they have a direct financial interest in the companies. *Business Week, February 28, 2000.*

TIAA-CREF Increases Focus On Executive Compensation

TIAA-CREF has revised its corporate governance policy, putting increased emphasis on executive pay and anti-takeover issues and, for the first time, calling for shareholder approval of all stock-based compensation plans. CREF has adopted five fundamental principles of compensation governance it will apply in voting its proxies. It says every company should clearly describe and explain its compensation programs and overall compensation philosophy in its proxy statement; provide cash pay that is reasonable and fair based on industry standards; disclose all fringe benefits; seek shareholder approval for all stock-based compensation plans, which should be directly linked to company performance; and have a compensation committee of independent directors who are knowledgeable in the field of executive compensation and who have independent access to professional compensation consultants. CREF voted against more than 30% of all stock plans in 1999, and expects that number to increase in 2000. *Council Research Service Alerts, March 20, 2000.*

Institutional Activism Wins Out

Two more companies have adopted shareholder proposals that called for terminating the companies' poison pill shareholder rights plans, and both proposals were submitted by public pension funds. Tenet Healthcare announced on March 6, 2000, that its board of directors had voted to redeem the poison pill it adopted in December 1998. The board took the action in light of the majority vote for the resolution at the company's 1999 annual meeting. The winning resolution was submitted by the Plumbers & Pipefitters National Pension Fund. Similarly, Tyco International adopted a resolution submitted by U.A. Local 343 Pension Trust Fund of Vallejo, California which called on the company to eliminate its poison pill shareholder rights plan and refrain from adopting any future pill without the prior approval of shareholders.

On a related note, the board of AHL Services approved a resolution prohibiting the company from repricing any stock options already granted to any employee or director of the company. The resolution was adopted in response to a shareholder resolution filed by the New York State Common Retirement Fund, and came in the wake of what some called a "knee-jerk" repricing of options in 1998. *Council Research Service Alerts, March 10, 2000.*

SEC Continues To Be Involved In Securities Litigation.

At the Council for Institutional Investors' third annual meeting with the SEC, attorneys with the SEC stated that the SEC plans to continue to be active filing *amicus* briefs in connection with securities class action lawsuits. In addition to filing *amicus* briefs on subjects such as the scienter standards of the Private Securities Litigation Reform Act, the SEC has been particularly active with respect to lead plaintiff issues. The SEC has filed *amicus* briefs in a number of significant securities fraud class actions, including *In re Oxford Health Plans, Inc. Securities Litigation,* and *In re Network Associates, Inc. Securities Litigation,* which strongly favor the appointment of institutional investors as lead plaintiffs in those cases. In particular, the SEC has taken the position that the aggregation of large groups of unrelated investors by attorneys seeking control of the cases violates the PSLRA and contradicts Congress' stated preference that securities cases be controlled by investors with significant holdings in issuers, particularly institutions.

SEC Addresses Rise In Accounting Fraud

The SEC's emphasis on accounting matters provided the focus for the annual "SEC Speaks" conference in Washington, D.C. in March. At the conference, the SEC addressed several issues concerning financial reporting and fraud, including accounting for business combinations and abuses in the area of revenue recognition. SEC Commissioner Isaac C. Hunt, Jr. noted that financial fraud "has gone far beyond the point of mere sloppiness" and added that the staff has seen SEC filings that are "downright misleading." A particularly troubling aspect of this trend, according to Commissioner Hunt, was that these frauds "are conducted by professionals, lawyers, accountants and high-level managers." The SEC further noted that a study conducted by the Committee of Sponsoring Organizations Report of the Treadway Commission determined that 83 percent of fraudulent financial statements involved the complicity of either the CEO or the CFO of the reporting company. *Federal Securities Law Reports, March 15, 2000.*

What Would Uncle Junior Say?

In the category of "life imitates art," a man who appeared on the hit HBO series "The Sopranos" was sentenced to two to six years in prison on April 12 for conning some 30 senior citizens out of $300,000 in a stock fraud scam. Thomas Bifalco Jr. of Brooklyn, N.Y. was sentenced after he pleaded guilty to running a boiler room operation out of an office on Wall Street and using high-pressure sales tactics to bully elderly investors into buying worthless stock in a company called Falcon Marine Inc. Ironically, Mr. Bifalco had a bit role in the episode of "The Sopranos" which featured a boiler room operation run by the title family, where the "brokers" lured investors into buying worthless stock in a company called Wubistics. The New York attorney general's office shut down Mr. Bifalco's boiler room in March 1999. For our readers who missed the last episode of "The Sopranos," Tony Soprano was forced to close his boiler room after he learned that a colleague had told the FBI of its existence. We note that this colleague of Mr. Soprano's will most definitely not be appearing in any further episodes of "The Sopranos." *Associated Press, April 12, 2000.*

SEC Abandons Plans To Start Decimal Pricing in July

On April 13, 2000, the SEC abandoned plans to implement decimal pricing of stocks on a six-month phase-in schedule beginning July 3, 2000. The SEC's decision was necessary because Nasdaq has stated that it will not be able to meet the deadline because of capacity problems. As a result, the SEC has set a new target date of March 31, 2000 for completion of marketwide decimalization, but noted that decimalization could occur earlier for exchange-listed stocks. *Securities Regulation & Law Report, April 17, 2000.*

Lawmakers Seek FASB Delay On Bid To End Pooling Method

Two Virginia lawmakers have asked the Financial Accounting Standards Board to delay action on its proposal to end the pooling method of accounting for business combinations until March 15, 2001, so that the SEC's Chief Economist will have time to study the issue. Under the pooling of interests method, the book value of the combining companies are joined, leaving no impact on the income statement of the combined company. Under the FASB proposal, the acquiring company would have to reflect on its books as goodwill the difference between the purchase price and the book value of the acquired company, and amortize or write-off this amount over a maximum of twenty years. Critics of this proposal, most of which are high-technology companies, claim that this creates an artificial drag on earnings, and that much of the recent growth in the high-tech sector of the economy would not have taken place under such a rule. *Securities Regulation & Law Report, March 27, 2000.*

Berkshire Hathaway's 1999 Annual Report

Berkshire Hathaway's 1999 Annual Report was filed in March and with it, Chairman Warren Buffet's always much-anticipated letter to shareholders. As usual, Mr. Buffet's letter was the epitome of full disclosure, noting that Berkshire Hathaway had the "worst absolute performance of my tenure and, compared to the S&P, the worst poor relative performance as well." Mr. Buffet graded his own performance in 1999 with a D and stated that "[e]ven Inspector Clouseau could find last year's guilty party: your Chairman." Mr. Buffet further commented that he expected the gain in Berkshire's intrinsic value over the next decade to "modestly" exceed the gain from owning the S&P.

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Informed Sources

INFORMED SOURCES features questions and answers that address issues presented by our readers. If you wish to submit a question, and we encourage you to do so, E-mail us at blbg@blbglaw.com, call us at 800-380-8496, or write to us at the firm address.

Q When an institutional investor's shareholder proposal is included in a company's proxy materials, what remedy does that institutional investor have when the company's response to the shareholder proposal is misleading or mischaracterizes the proposal?

A Rule 14a-8 of the Securities and Exchange Act of 1934, permits shareholders who have owned either 1% of a company's outstanding equity securities or $1,000 worth of its stock for a specified period of time to submit proposals for a vote of the company's shareholders. Under that Rule, sponsors may append a statement in support of their resolution, and the company may include a written response to such shareholder proposals.

Institutional investors have been at the forefront of submitting shareholder proposals. Just this spring, for example, institutional investors have initiated campaigns against three major U.S. corporations, Louisiana-Pacific, Cooper Tire & Rubber and Great Lakes Chemical, to withhold votes from company-sponsored director nominees because those companies failed to adopt institutional investor-sponsored shareholder resolutions that had won majority votes in 1999. While institutional investors do not appear to be having difficulty meeting Rule 14a-8's criteria for submitting shareholder proposals, what remedy does an institutional investor have if one of its shareholder proposals is mischaracterized by the company, or if the company makes misleading statements in its proxy materials in an effort to defeat the proposal?

The issue of misleading company statements in response to a shareholder proposal was addressed by the Court of Appeals for the Second Circuit in *United Paperworkers Int'l Union v. International Paper Co.* At issue in *International Paper* was the company's statement in its proxy materials encouraging shareholders to vote against a shareholder proposal requesting the adoption of governance principles related to environmental responsibility and accountability. In that statement, International Paper quoted its own principles in glowing fashion, but failed to adequately describe its significant environmental failures. The Court found International Paper's statement misleading under Rule 14a-9 of the Securities and Exchange Act, which prohibits the inclusion in a proxy statement of

> *any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.*

The application of Rule 14a-9 to a shareholder proposal is especially significant. International Paper argued that the Rule should not apply, because such a shareholder proposal was merely precatory (i.e., not binding on the Board), and, therefore, the Board could have ignored it even if it had received the necessary majority of shareholder votes. According to International Paper, any misleading statement the company may have made did not "cause" any direct economic damage to shareholders. This argument, had it been adopted by the Court, effectively would have denied shareholders any remedy under Rule 14a-9 for misleading statements or omissions made by Boards in response to precatory shareholder proposals, like those seeking to improve corporate governance policies, which have no direct economic effect on shareholders.

The Court rejected International Paper's argument, however. Recognizing that substantially all shareholder proposals were precatory in nature, and, therefore, that a causal link between the misleading statement or omission and some direct economic harm to shareholders always would be lacking, the district court held that requiring such a strict causal link would undermine the purposes the Securities and Exchange Act and the shareholder proposal rule. Crediting International Paper's position also would have resulted in a disturbing anomaly in securities regulation: Under Rule 14a-8, a shareholder has an implied right of action against a company if the company wrongfully excludes a shareholder proposal from the proxy materials, but, simply because the proposal is precatory, that same shareholder would have no right of action under Rule 14a-9 if the company then made misleading statements in its response to the proposal. As a result of its violations of Rule 14a-9, International Paper was ordered to include the shareholder proposal in the proxy materials for its next annual meeting.

As held in *International Paper*, Rule 14a-9 provides a meaningful remedy to an institutional investor when a company's response to the institution's shareholder proposal is misleading or mischaracterizes the proposal.

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Pfizer for $93.9 billion, or 30% more than shareholders would have received in the competing AHP transaction.

In an age of mega-mergers and increasingly complex corporate transactions, institutional investors can play an important role in ensuring that boards of directors are held accountable to the public shareholders of the companies in which they invest.

Institutional investors scored another victory recently, albeit on a smaller scale, in connection with the proposed acquisition of jungle theme restaurant chain Rainforest Café by Landry's Seafood for approximately $120 million, or less than half Rainforest's book value. Although the merger appeared to be an arms-length transaction on the surface, the merger documents revealed that every member of the Rainforest Board suffered from significant conflicts of interest that likely prevented them from acting in the best interests of the Company's shareholders in considering the transaction. Among other things, the terms provided for all of the Rainforest directors, either directly or through companies they controlled, to receive cash payments of $8 million upon consummation of the merger, separate and apart from any consideration provided to Rainforest public stockholders in return for their shares. The deal also included provisions forbidding Rainforest from soliciting or considering other offers for the Company, which resulted in at least one potential acquirer falling by the wayside.

Given that Rainforest stock is held predominantly by smaller shareholders, this transaction could easily have been consummated despite its inadequacies for lack of organized resistance. Instead, the Heartland Value Funds, a multi-billion dollar mutual fund that owns approximately 6% of the Company, commenced an action charging the directors of the Company with self-dealing, and seeking to enjoin the merger from taking place. As Heartland pressed its case, the State of Wisconsin Investment Board, which owns over 10% of Rainforest, launched a proxy solicitation campaign to defeat the merger, highlighting the low price offered for the Company and the conflicts of interest raised in Heartland's complaint. Recognizing that the efforts of Heartland and SWIB had galvanized shareholder opposition to the proposed

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COURT PROHIBITS MISLEADING SOLICITATION OF CLASS MEMBERS

By Max W. Berger and Rochelle Feder-Hansen

The court overseeing the McKesson securities litigation has recently issued an order castigating the misleading mass solicitation undertaken by two well known plaintiffs' law firms that were unsuccessful in their bid to obtain a leadership role in this consolidated class action. The firms, using direct mailings and internet and website postings, urged class members to retain them to file "individual" actions. The solicitations also included a pre-authorization to opt those persons out of the class action.

The court-appointed lead plaintiff, the New York State Common Retirement Fund (the "NYSCRF"), learned of the campaign and reviewed the solicitation materials. It concluded that the materials were misleading and seriously undermined the goals of the Private Securities Litigation Reform Act of 1995 (the "PSLRA"). Therefore, the NYSCRF determined to challenge the solicitation in court. The Federal Court in California agreed with the NYSCRF's assessment. In an unprecedented decision, Judge Whyte ordered that: corrective notice be given to all recipients of the solicitations; all retainers could be unilaterally rescinded; any attempt in the future to obtain pre-class certification opt-outs is precluded. The court also set forth information required to be included in any future solicitation, including, requiring a prominent designation that the solicitation is an "Attorney Advertisement — Not An Official Notice — No Obligation to Respond." The soliciting attorneys must pay for the corrective notice.

The court, in compliance with the provisions of the PSLRA, had previously determined that the more than 50 class actions filed on behalf of purchasers of McKesson and HBOC securities alleging various violations of the federal securities laws should be consolidated and proceed as one action. In consolidating the actions, the court expressly rejected the argument of numerous plaintiffs' attorneys, *including the soliciting attorneys'*, that speculation about purported conflicts among class members militated against consolidation. In appointing the NYSCRF as lead plaintiff for the consolidated action, the court found, not only that it had the largest financial interest in the litigation, but also that it satisfied all of the other requirements of the PSLRA and was, therefore, the most adequate person to represent the interests of all class members.

Judge Whyte found that the solicitation materials were inimical to the goal of the PSLRA to "prevent lawyers from fomenting unnecessary and duplicative litigation."

Notwithstanding these findings by the court, the soliciting attorneys disseminated a "notice" directed to class members "representing" that the court-appointed lead plaintiff had conflicts and, therefore, would not prosecute certain claims vigorously in the consolidated action. The solicitations also represented that, for class members to protect their interest in these claims, they needed to act now and file an "individual" action with the soliciting attorneys. Though the actions were to be filed as individual actions, they were going to be aggregated and prosecuted as a group under the supervision and control of a "Steering Committee," hand-picked by the soliciting attorneys. The solicitation materials included a retention agreement that, among other things, authorized the soliciting attorneys to opt that person out of the class.

Judge Whyte found that the solicitation materials were inimical to the goal of the PSLRA to "prevent lawyers from fomenting unnecessary and duplicative litigation." He stated that they appeared to contemplate a scheme that would resurrect the "evil of past securities litigation [which] was the control that plaintiff's counsel exercised over large aggregated masses of clients, who minimally supervised their lawyers through unwieldy steering committees." Judge Whyte concluded that "the solicitation materials were misleading, if not intentionally deceptive."

The full text of the court's Order can be accessed at www.cand.uscourts.gov. (Click on "Recent Orders," then "Judge Whyte.")

In January, we issued a bulletin alerting you to deceptive mass solicitations undertaken by some law firms to secure lead plaintiff positions in securities class actions. See ***Institutional Investor Advocate*** January, 2000 Bulletin. This attempt to gain a "position" after losing the bid to be appointed lead counsel, is a new twist on the "solicitation" process. The NYSCRF's vigilance which brought the matter to the court's attention, and the order obtained, represent a significant victory for all class members and a stellar example of the effectiveness of an institutional investor protecting the class action process. The inventiveness of some traditional class action lawyers, however, knows no bounds when it comes to devising ways to get around the provisions of the PSLRA; investors must remain ever wary.

Bernstein Litowitz Berger & Grossmann LLP represents the Lead Plaintiff in the McKesson consolidated class action.

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ENDING MICKEY MOUSE CORPORATE GOVERNANCE

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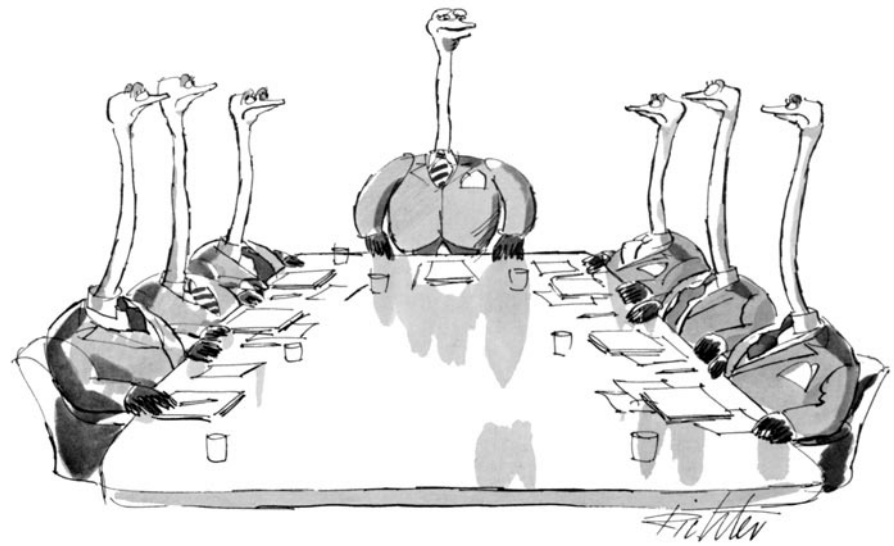
acquisition, Rainforest and Landry's abandoned their merger plans. Even more significantly, SWIB is now reaching out to the Rainforest board to discuss appropriate ways to increase shareholder value.

Institutional investors were even able to salvage a partial victory in the *Disney* case. Although the Court was critical of the conduct of the litigation by the lead counsel, it praised the contribution of the prestigious Council of Institutional Investors, which submitted a non-party amicus brief to the Court arguing that the Disney board "should have taken steps to assure even greater independence of directors." Although the Court found that the Council's suggestions were not required under Delaware law, it nevertheless agreed to allow plaintiffs to submit an amended complaint "[b]ecause of the unusual nature of this case and the rulings in this opinion . . ." One can only speculate what role the input of substantial institutional shareholders played in reviving a case that had been dismissed with prejudice in the Court below, but the favorable response accorded its input should encourage other institutional investors to play a more active role in corporate governance litigation.



"The motion has been made and seconded that we stick our heads in the sand."

In an age of mega-mergers and increasingly complex corporate transactions, institutional investors can play an important role in ensuring that boards of directors are held accountable to the public shareholders of the companies in which they invest. Substantial investors have unparalleled knowledge and expertise to manage shareholder breach of fiduciary duty litigation, and derail a challenged transaction even before a decision by a court is required. Assuming control over shareholder litigation also can ensure that class actions are managed in the best interests of the company and its shareholders, and that lead counsel prosecutes the claim in an appropriate manner. By continuing to challenge corporate directors to observe their fiduciary duties, institutional investors will serve the goal of all investors large and small—maximizing shareholder value.

Bernstein Litowitz Berger & Grossmann LLP served as counsel to the Louisiana public pension funds in the Warner-Lambert litigation and also represented the Heartland Value Funds in the Rainforest action.

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Bernstein Litowitz Berger & Grossmann LLP prosecutes class and private actions, nationwide, on behalf of institutions and individuals. 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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AUDITORS UNDER SIEGE

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resources consulting, and corporate finance consulting. As a result, non-audit consulting fees have increased as a percentage of the largest accounting firms' revenues from 15% in 1978 to 24% in 1990 and to 38% in 1996.

This explosion in growth and demand for non-audit services has resulted in auditing firms "lowballing" their quoted auditing fee (whereby firms offer big reductions in their audit fees), in order

As business consulting services continue to grow at a rapid clip in this Internet age and auditing firms continue to direct more of their resources toward providing non-audit services to its clients, the issue of auditor independence will only intensify.

to more easily leverage themselves into the companies to cross-sell the firm's more profitable non-auditing services, usually on a no-bid basis. For example, in 1991, PWC won a contract to audit Prudential after offering a discount of almost 40% off its original quote. By the time Prudential dropped PWC as its auditor last year, PWC's annual consulting fee was more than 300% greater than PWC's annual audit fee. What is the reasonable investor to think when an auditing firm certifies a company's financial statements as complete and accurate, yet the auditing firm is generating three times its auditing fee from providing business consulting to the same company? Clearly, the independence of the auditor is contaminated, the auditor is more reticent than ever to disagree with corporate management on financial reporting issues, and the credibility of an industry which is supposed to be free of potential or actual conflicts of interest is diminished.

Auditing the Auditors

As business consulting services continue to grow at a rapid clip in this Internet age and auditing firms continue to direct more of their resources toward providing non-audit services to its clients, the issue of auditor independence will only intensify. In fact, Lynn Turner, chief accountant for the SEC, recently advocated that public companies should disclose all business links with outside auditors so shareholders can better evaluate possible conflicts of interest. Ms. Turner stated that "given the explosion of these [non-audit] services, it's time for the public to know" and urged that mandatory disclosure of possible conflicts of interest should be required by the Independence Standards Board, a self-regulatory organization, or a new SEC rule. Clearly, someone needs to watch the watchdog.

The SEC's willingness to raise tough questions about conflicts of interest has been rewarded by the recent separation of auditors' consulting arms. PWC recently announced that it will split its business into two parts, with separate management teams and boards, one to run the audit business, the other to run the consulting business. Similarly, following the SEC's report exposing PWC's ethical violations, Ernst & Young sold its consulting arm to Cap Gemini, a French computer-services company. The SEC should keep the heat on auditing firms to divest or at the very least, come up with some reorganization scheme that protects shareholders from actual or potential conflicts of interest. Independence and integrity have always been the bedrock of the accounting profession and, in order to inspire investor confidence in the integrity of the American financial market, the auditor must remain independent.

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