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Advocate

A SECURITIES FRAUD AND CORPORATE GOVERNANCE QUARTERLY

MY EXPERIENCE AS A LEAD PLAINTIFF

By R. Randall Roche, Esq.

On January 28, 1998, the Louisiana School Employees' Retirement System ("LSERS") and the Louisiana Municipal Police Employees' Retirement System ("LMPERS" and, collectively, the "Louisiana Retirement Systems") filed a securities fraud class action against 3Com Corporation on behalf of a class of purchasers of 3Com stock. These public pension funds successfully sought to become lead plaintiffs, oversaw the prosecution of the case, and, after nearly three full years of intensive and hard-fought litigation, achieved a landmark settlement of $259 million in cash. The settlement is one of the largest ever obtained from a corporate defendant in a securities case since the passage of the Private Securities Litigation Reform Act of 1995 (the "PSLRA").

R. Randall Roche, Esq.

In keeping with our goal to present timely and meaningful information concerning class action litigation to institutional investors, we believe it is appropriate to describe the critical role played by the Louisiana Retirement Systems in the prosecution and ultimate resolution of the case, and to present the Systems' viewpoint of the litigation. Accordingly, we asked R. Randall Roche, Esq., the General Counsel of the LSERS and the LMPERS, to provide his thoughts on his experiences serving as lead plaintiff in In re 3Com Corp. Securities Litigation.

In late 1997, the LSERS and the LMPERS became aware that numerous class actions had been filed against 3Com, alleging that 3Com had misrepresented its financial condition and issued false financial statements during the period between April and November 1997. Many of these alleged misrepresentations were made in connection with 3Com's merger with U.S. Robotics Corporation in what was, at the time, the largest merger in the history of Silicon Valley. Although neither the LSERS nor the LMPERS had ever served or sought to serve as a lead plaintiff in a securities class action before, we were aware of the PSLRA and the fact that Congress enacted the PSLRA because it specifically wanted institutions to control securities class actions. The case caught our attention for two reasons: first, the Louisiana Retirement Systems had made substantial purchases of 3Com stock during the Class Period and had sufficient significant losses; and second, the allegations of wrongdoing were particularly egregious. Indeed, in October 1997, The New York Times had published an article which basically accused 3Com and U.S. Robotics of "accounting alchemy" and of deliberately manipulating U.S. Robotics' financial results to complete the merger. Moreover, after the merger, the senior officers and directors of 3Com and U.S. Robotics sold more than $200 million worth of their 3Com stock holdings.

In sum, we knew this was an important case, both from the standpoint of deterring financial fraud and of attempting to recoup our losses. However, most, if not all of the cases that had been filed had been brought by small, nominal shareholders who would likely have no involvement in the litigation and would not be able to exercise any control over the attorneys. We strongly believed that, if an institution did not step forward, we were concerned that the case could settle for "pennies on the dollar." Accordingly, although we knew that the litigation would require a substantial commitment from us, we decided to move to be appointed lead plaintiff.

Continued on page 3

AUDITOR INDEPENDENCE: FACT OR FICTION?

Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession's strength and its stature.

– Council of the American Institute of Certified Public Accountants

By Jeffrey N. Leibell

The recent financial irregularities at such companies as Cendant Corporation, Oxford Health Plans, MicroStrategy, Waste Management, Sunbeam Corporation, Livent, and McKesson HBOC as a result of which well over $88 billion in market value was wiped out were so critical that the SEC began to wonder whether or not the auditors were properly doing their jobs. One focus of the SEC was on auditor independence. For example, four of the most senior financial officers of CUC International, Inc. (the Cendant predecessor that had over $500 million of fraudulent earnings over a three-year period), including the CFO and Controller, were former employees of CUC's "independent" auditor Ernst & Young LLP. A 1999 SEC special review of Pricewaterhouse Coopers LLP uncovered more than 8,000 violations of independence rules governing investments by auditors and their relatives in the securities issued by audit clients.

If an auditing firm receives substantial fees by providing non-audit services to an audit client, is that auditor still sufficiently independent? SEC Chief Accountant Lynn Turner put it this way: "We're seeing situations where the adjustment is so big, the errors so humongous, that it's inconceivable the auditors didn't see them. It boggles the mind."

In the wake of these accounting debacles, SEC Chairman Arthur Levitt expressed concern over the changing relationship between an auditor and its clients. Chairman Levitt observed that the Big 5 public accounting firms, which audit 90% of the public companies in the U.S., "position themselves globally as 'multi-disciplinary professional service organizations' rather than accounting firms," so that auditor "independence if not in fact, then certainly in appearance,

Continued on page 4

Inside Look

With this issue we are celebrating the second anniversary of the *Advocate*. In looking back over the last two years, I believe we have continued to strive to meet our purpose and goal in publishing the *Advocate*: to provide institutional investors with cutting edge information on issues affecting them in the securities class action and corporate governance arenas. We hope that you have enjoyed the publication and find it a useful tool for keeping up to date in this area.

Throughout this year, we have focused on several issues relating to the lead plaintiff landscape, in general, and how institutional investors have become increasingly more successful at taking control over securities class actions. We alerted you — in a special *Advocate Bulletin* — to the fact that institutions were being duped by a practice by certain class action lawyers to deceive them into signing up to serve as lead plaintiff in class actions. We also highlighted the importance of having institutional investors as lead plaintiffs through our article discussing the settlement of the Cendant litigation and our article exploring the involvement of institutional investors in several corporate governance litigations. Importantly, we began (and hope to continue) having outside members of the institutional investor community author articles addressing some of these important issues.

In this *Advocate*, we continue our goal of bringing you articles and opinions directly from the institutional investor community. R. Randall Roche, the General Counsel of the Louisiana School Employees' and Municipal Employees' Retirement Systems, in "My Experience As A Lead Plaintiff", recounts his Funds' experience serving as lead plaintiff in the recently settled 3Com Securities Litigation. The Funds were appointed lead plaintiffs in this action in late 1997 and were instrumental in achieving the landmark settlement of $259 million in cash, the largest securities fraud settlement in California.

Also, in "Auditor Independence: Fact or Fiction?", Jeffrey Leibell, a senior associate at the firm and a former audit manager in a Big 5 public accounting firm, addresses the SEC's recent activities in the always important area of auditor independence. The Eye On The Issues section, written by Steve Mellen, provides you with a snapshot of recent important legislative and regulatory developments, as well as decisions of interest since our last issue. And in our Informed Sources column, we answer one of your questions concerning the importance of electronic evidence in the prosecution of securities fraud lawsuits.

We hope you find this issue interesting and welcome any comments, suggestions or feedback you may have.

Most importantly, we at Bernstein Litowitz Berger & Grossmann LLP wish you, your colleagues, and your families all of the joys of the holiday season and a happy and healthy New Year.

Mark W. Berger

LEAD PLAINTIFF

Continued from page 1.

We considered a number of law firms and decided to retain the firm of Bernstein Litowitz Berger & Grossmann LLP. We chose Bernstein Litowitz because the firm had extensive experience in securities litigation and because its securities practice catered to institutional investors. Bernstein Litowitz agreed to represent the Louisiana Retirement Systems on a contingency basis, and further agreed that any fee would be substantially less than the one-third fee that was commonly sought in securities class actions. We made it clear from the outset that we expected to be in control of the litigation, and that we wanted regular periodic reports from our counsel on the case. Bernstein Litowitz agreed, and not only respected our wishes, but welcomed our involvement in all facets of the litigation from the pleading of the complaint through the settlement negotiations.

The Louisiana Retirement Systems took their role as lead plaintiffs very seriously, and we were actively involved in the case from the outset. As General Counsel of the LSERS and LMPERS, I had primary responsibility on behalf of the Louisiana Retirement Systems for supervising the prosecution of the action. In that capacity, I reviewed all of the important pleadings in the case, and attended the hearing on defendants' motion to dismiss the complaint. I was consulted on all major strategic decisions. I also participated in several face-to-face meetings with defense counsel regarding the scope of discovery and defendants' objections.

In the summer of 2000 after more than two years of intensive litigation the parties agreed to mediate the litigation before a federal Magistrate Judge. It was during the settlement negotiations that the Louisiana Retirement Systems had their greatest impact, and we were, I believe, instrumental in obtaining the settlement. The parties held four separate mediation sessions in San Jose, California over a four-month period, and I attended each session. Our presence at the mediation gave the plaintiffs credibility with the defendants and the mediator, and sent a message that this was not going to be "business as usual," that is, the situation where there is no real party interest on the plaintiffs' side spearheading the interests of the Class. We were consistently looked to by the mediator and the defendants for our views on the settlement, and we rejected numerous offers that were very substantial.

> *The New York Times had published an article which basically accused 3Com and U.S. Robotics of "accounting alchemy" and of deliberately manipulating U.S. Robotics' financial results to complete the merger.*

At the same time, however, we had to balance our goal of obtaining a meaningful recovery with the reality that this was an extremely risky litigation. Establishing defendants' liability in any securities class action is extremely difficult, and liability in this case was far from assured. Moreover, proving that the Class was damaged by the alleged fraud also would have been challenging. The defendants argued that virtually all of the decline in the price of 3Com stock that occurred was not related to our case, but to general market conditions and an overall downturn in the Nasdaq market. While our damages expert disagreed, there was no question that this was a significant risk in the case. We were faced with a situation where we could have proved that defendants made misrepresentations, but then have a jury determine that we were entitled to no recovery. Finally, significantly, we had to take into consideration the delays inherent in any litigation. The case had been proceeding for nearly three years, and if we were unable to reach a resolution, it would undoubtedly be at least another year before we got to trial. Even then, we would have to deal with the inevitable appeals that follow a jury verdict, which would have further delayed any recovery. So, based upon our consideration of these factors, we decided to accept defendants' offer of $259,000,000. While we will not know for sure what percentage of our damages this amount represents until all of the claims are received and processed, we expect to recover at least 30 percent and possibly more than 50 percent.

In conclusion, we were greatly pleased with our decision to become lead plaintiffs. While the case did require my attention, the PSLRA allows for lead plaintiffs to recover their reasonable costs and expenses relating to their involvement in the case, including lost wages. The settlement we were able to obtain is an outstanding result for the Class and will result in the class recovering a significant percentage of their loss. I have no doubt that the involvement of the Louisiana Retirement Systems materially increased the size of the settlement.

R. Randall Roche, Esq., the General Counsel for LSERS, can be reached via e-mail at rroche01@ix.netcom.com. Max W. Berger and Douglas McKeige, partners at Bernstein Litowitz Berger & Grossmann LLP, and Steven Singer, a senior associate at the Firm, handled the case for the Louisiana Retirement Systems.

AUDITOR INDEPENDENCE

Continued from page 2.

becomes a more elusive proposition." For SEC audit clients of the Big 5 firms, the ratio of accounting and auditing revenues to consulting revenues dropped from approximately 6 to 1 in 1990 to 1.5 to 1 in 1999.

Because auditor objectivity is critical to investor confidence, the SEC becomes apprehensive at the mere suggestion that auditor independence has been or even appears to have been impaired. As a result, in May 2000 Chairman Levitt asked the SEC staff to prepare an SEC rule-making initiative designed to address fundamental policy questions, including whether there should be limits on the types of services that an auditor may render to a public audit client, how certified public accounting firms should be structured to ensure independence, and whether those firms should be permitted to affiliate with entities that provide services to the firms' audit clients that the firms themselves would not be allowed to provide directly to those clients.

There are many reasons to restrict or prevent an auditor from providing non-audit services to public audit clients. When an auditing firm provides such services to an audit client, the auditing firm actually then has two clients. With respect to the consulting services, the auditing firm's "client" is its client's management and with respect to audit services, the "clients" are the audit client's shareholders, and anyone else who relies on an auditor's opinion. It is obvious that, in serving these two groups, the auditing firm is subject to conflicts of interest. Even when an auditing firm correctly determines that providing certain non-audit services to an audit client would not impair the auditing firm's independence in fact, the apparent conflict of interest especially given the auditing firm's self-interest in an outcome that permits the firm to provide the non-audit services created by assessing its own independence causes the loss of the credibility of the auditing firm's report.

The accounting profession, sensing that their lucrative non-audit service business was in jeopardy, did not take the SEC's rule-making initiative sitting down. They lobbied Congress to compel Chairman Levitt to stop. They caused the American Institute of Certified Public Accountants ("AICPA"), the professional association that acts as the accounting profession's main governing body, to cut off funding of the Public Oversight Board (the "POB"), the independent entity established by the AICPA in consultation with the SEC to assure that the public interest in independent auditing received appropriate consideration at all times. They argued that the proposed rules were unnecessary, claiming that there was no proof that the conflicts inherent in providing substantial non-audit services to public audit clients actually impaired an auditing firm's independence, and that a proscription on non-audit services would diminish audit effectiveness because it would reduce the auditor's knowledge of the client (presumably gained through providing non-audit services) and because the most talented professionals would no longer seek employment with auditing firms. But their loudest objection was that certified public accountants would never risk their independence over consulting fees.

The accounting profession's response is quite troubling. If the AICPA, which is dominated by the Big 5 public accounting firms, can terminate its funding of the POB when the AICPA objects to the POB's special investigations into auditor independence, the accounting profession's so-called self-regulation is a myth. The accounting profession's political efforts subvert the SEC's mandate; after all, the SEC, not the Big 5 accounting firms, regulates the U.S. securities markets. The claim that the proscription on non-audit services would undermine

Continued on page 7

Quarterly Quote

"As a practical matter, there is little that the [Securities and Exchange] Commission can do about the overall decline in the legal threats facing an auditing firm that misbehaves. But precisely for this reason, the Commission has correspondingly more reason to be concerned about the increased incentives to acquiesce in accounting irregularities that accompany the growth in non-audit services as a percentage of the total revenues of auditing firms. Thus, prophylactic limitations on the ability of auditing firms to market non-audit services to auditing clients makes sense — less as the ideal regulatory tool than as the best available mechanism."

— Testimony of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law Columbia University Law School Before the Securities Exchange Commission on July 26, 2000.

Eye On The Issues

LEGISLATIVE/REGULATORY UPDATES AND RECENT DECISIONS OF INTEREST

By Steven E. Mellen

Institutional Shareholders Take Charge. Shareholder proposals are widely recognized as an imperfect method for institutional investors to make their voices heard on corporate governance issues. At its Fall 2000 meeting, the Council of Institutional Investors took a major step toward developing a superior alternative to shareholder proposals when it voted to explore the idea of running its own nominees for board seats where the Council determines directors' performance to be subpar. The Council also agreed to toughen its position on shareholder proposals, discarding the prior policy which permitted directors to decline to adopt measures recommended in shareholder proposals where they articulate "compelling reasons for not doing so" in favor of a stronger policy which provides unequivocally that shareholder proposals should be followed by corporate boards without exception. **Council Research Service Alerts, Oct. 6, 2000.**

Signing SEC Filings Subjects Corporate Officers To Liability. A significant ruling from the Ninth Circuit Court of Appeals provides that officers who sign SEC filings containing false financial information can be held liable for making a false "statement" under the securities laws, even if they did not personally participate in the drafting of the financial information. The court noted that its ruling helps protect investors by giving officers the responsibility to ensure that corporate filings are accurate. Otherwise, observed the court, senior officers would "be allowed to make important false financial statements knowingly or recklessly, yet still shield themselves from liability to investors simply by failing to be involved in the preparation of those statements." **Federal Securities Law Reports, Oct. 11, 2000.**

Investment Analyst Conflicts of Interest Spark Controversy. It seems every day brings another news item calling into question the reliability and independence of investment analysts. Last November, well-known telecom analyst Jack Grubman of Salomon Smith Barney upgraded AT&T stock to a "buy," just a short while before AT&T led a plunge in the telecom sector which has cut its stock price in half. While nobody expects analysts to have a flawless track record, observers have noted that Grubman's unfortunate pick was followed soon after by Salomon being awarded a lucrative piece of underwriting business on the $10.6 billion IPO of AT&T Wireless Group. In a world where investment banking firms fear repercussions for negative analyst reports in the form of lost underwriting and consulting business, it is getting tougher for institutional investors to know who they can trust. **Wall Street Journal, Oct. 4, 2000.**

Auditor Independence Remains on the Front Burner. SEC Chairman Arthur Levitt's crusade to keep auditors independent by placing strict limits on auditors' ability to engage in lucrative consulting work for the same companies they audit received front-page billing in a recent issue of Business Week. The article pointed to two recent securities fraud cases of significance Waste Management, Inc. and MicroStrategy Inc. as textbook examples of what happens when the need to obtain consulting work compromises the independence of auditors. Major accounting firms are already hedging their bets against the day when Levitt's proposals become reality. Ernst & Young already unloaded its consulting arm earlier this year, and PricewaterhouseCoopers LLP and KPMG are in the process of doing the same. **Business Week, Sept. 25, 2000.**

Sweetening the Deal Can Leave a Bitter Taste. The SEC's "Staff Accounting Bulletin No. 101," issued last year to curb out-of-control revenue recognition practices by many companies, continues to stir controversy. Many recent securities fraud cases have featured transactions where a manufacturer ships its product and recognizes revenue immediately, but agrees to defer payment for a period of time or until the product is installed and operational. Such transactions are often mere shams designed solely to inflate revenues, and the SEC's bulletin would help control this practice by mandating that companies in a wide range of specified industries may not recognize revenue on such transactions until the product is actually installed or paid for. Some manufacturers have complained, however, contending that permitting a customer to defer payment is often a legitimate part of "closing the deal." Pressure by these manufacturers' lobbyists has resulted in two delays in implementation of the bulletin as well as an angry letter from Banking Committee Chairman Phil Gramm to SEC Chairman Levitt. It remains to be seen whether this type of pressure will ultimately prevent the SEC's rules from taking effect altogether. **Forbes, Oct. 16, 2000.**

SEC To Expand Options Disclosure Requirements. One way for prudent investors to ensure that their stock holdings are not unwittingly diluted is to keep close tabs on companies' issuance of stock options to their employees. Current SEC rules, however, only require companies to disclose options awarded to their five top executives. This will change soon as a consequence of the SEC's impending move to require disclosure of all stock options, even those awarded to rank-and-file employees. This information will undoubtedly assist investors in accurately evaluating the worth of their holdings. **Bloomberg News, Nov. 3, 2000.**

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 How important is electronic evidence in a securities fraud lawsuit, and what should a lead plaintiff expect its law firm to do when pursuing such evidence?

A Electronically-stored information can be extremely valuable in litigation. E-mail, in particular, often provides powerful evidence of corporate fraud. These messages frequently reflect the spontaneous comments and chatty reactions that high-ranking company personnel would never distribute on paper. E-mail, moreover, has a tendency to proliferate. A recipient can "delete" his or her copy, but forwarded copies remain. Once discovered, E-mail messages convey far more information than hard copy memoranda or business letters. An E-mail message usually identifies its sender, all recipients, the date sent, and whether the correspondence was opened or forwarded to others. This evidence can help prove critical facts, like whether a particular officer knew of a business practice or decision.

Due to its extraordinary evidentiary value, E-mail has played a key role in many high-profile cases. The national press frequently cites the case of Lieutenant Oliver North. He was convicted for his role in the Iran-Contra affair based in part on e-mail evidence. North assumed incorrectly that "deleting" the messages destroyed them, but government investigators resurrected his E-mail from routine backup tapes. Likewise, independent investigator Kenneth Starr recovered e-mail exchanges between Monica Lewinsky and Linda Tripp to corroborate his case against President Clinton. Damaging E-mail also played a pivotal role in Microsoft's antitrust trial, including messages that flatly contradicted Bill Gates' sworn deposition testimony.

Corporate America has learned the lesson of these cases. Increasingly, companies are enacting "sweep and destroy" policies in an effort to eliminate as much inculpatory E-mail as possible before litigation starts. Moreover, unethical defendants take steps to destroy electronic evidence even after a lawsuit is filed. Consequently, counsel for plaintiffs should develop a plan at the outset that first preserves all relevant electronic evidence and later focuses on the key evidence.

Even before the formal discovery process begins, counsel should place the defendant and key third parties on notice with specific written instructions for preserving electronic evidence. Under the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), formal discovery is postponed until after resolution of any motion to dismiss the complaint. In the interim, defendants have an affirmative obligation to preserve all documents, including electronically-stored data. This general duty, however, may mean one thing to the company's legal department and something else entirely to the computer department. Counsel, therefore, should instruct the company to take all necessary steps to preserve electronic information, including: (1) stop any rotation, alteration or destruction of electronic media; (2) stop destroying or discarding original documents, back-up tapes, electronic mail, files, and file fragments; (3) notify every employee of the duty to preserve electronic documents, including, but not limited to, E-mail; (3) retain all electronic storage devices that are replaced or upgraded; and (4) maintain a log that identifies all individuals with access to electronic data, including back-up data and electronic recovery data.

The next step is formal discovery. Although computer technology is complex and constantly changes, the traditional rules of discovery govern electronic evidence. Under these rules, lead plaintiff's counsel should promptly depose the company's "information systems manager," or similar person, to assure that the company effectively halted its destruction of electronic information. Moreover, this person can testify about the company's method and location for storing data, its format, the programs for inputting and retrieving information, and all backup procedures. Such information is critical to understanding the company's systems and to framing future discovery.

Lead plaintiff should expect its counsel to pose requests for electronic evidence correctly. By using specific names for data and precisely describing all possible locations for the information, counsel can capture all relevant evidence. Recovering such valuable evidence requires the effective use of a computer forensic expert and special machines. Working together, lead plaintiff's counsel and a computer expert can reduce the time and expense of restoring and reviewing numerous backup tapes. Then, by applying appropriate narrowing parameters and technology, lead plaintiff's counsel can focus on the key evidence for use at trial or to force a favorable settlement.

AUDITOR INDEPENDENCE

Continued from page 4.

audit effectiveness is an unfounded parade of horribles. Generally Accepted Auditing Standards require auditors to obtain a sufficient understanding of their audit client's business. The accounting profession is, thus, complaining that auditors may no longer free ride on consultants. The claim that talented professionals will not become accountants if accounting firms cannot provide non-audit services to audit clients ignores the fact that, prior to the increase in non-audit services between 1990 and 1999, accounting firms had no difficulty recruiting and retaining skilled professionals. And if accounting firms cannot provide non-audit services to their own audit clients, they may provide those services to the audit clients of other auditing firms. The Big 5's most vociferous argument ignores the fact that accountants regularly assess whether their risk of loss from taking a particular position is adequately compensated. If the risk is adequately compensated, the client's position is supported by the auditor; if, on the other hand, the risk is too great (i.e., cannot be adequately compensated), then the client's position is rejected by the auditor.

On November 14, 2000, the SEC announced that it had reached agreement with four of the Big 5 accounting firms on a new auditor independence rule that will substantially reduce the amount of consulting work that the firms can do for their audit clients. The deal on a new rule to be adopted by the S.E.C. came after long negotiations. The new rule represents a compromise between the S.E.C.'s original proposal, which would have banned certain activities, and the stiff opposition from the Big 5 accounting firms, which argued that no new rules were needed. The new rules will restrict the amount and nature of the work that auditing firms may perform for their clients, and will require that the audit committees of corporate boards consider whether any non-audit services are consistent with maintaining auditor independence. The SEC referred to this use of audit committees as a "private sector solution" that will assure that auditor independence is protected. The rule will require public disclosure of the amounts of audit and non-audit fees paid to auditing firms, a move that could show if auditors are getting the bulk of their business from a client's non-audit work. We will continue to monitor developments concerning auditor independence. It is imperative that institutional investors understand just what constitutes auditor independence before they choose to rely on an auditor's unqualified report on a public company's financial statements.

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a happy, healthy and prosperous

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