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A SECURITIES FRAUD AND CORPORATE GOVERNANCE QUARTERLY

LEAVING MONEY ON THE TABLE

ARE YOU COLLECTING ON YOUR CLAIMS?

By Douglas McKeige

Douglas McKeige

Doug McKeige, a managing partner at BLB&G, primarily prosecutes securities claims on behalf of public retirement systems. Mr. McKeige is a popular speaker and lecturer on the subject of securities law and is a member of the National Association of Public Pension Attorneys, the Society of Pension Professionals and the National Association of State Retirement Administrators. He can be reached at 212-554-1481 and at doug@blbglaw.com.

Virtually every financial institution with significant sums invested in the U.S. securities markets has been part of securities class actions for decades — whether they have known it or not. A federal securities class action is prosecuted by a lead plaintiff for the benefit of all purchasers — whether individuals or institutions — that purchased stock or bonds of the company that is the center of the allegations. When a case has been resolved and money is recovered for the class, every institution and individual in the class is entitled to get their piece of the recovery. Unfortunately, it appears that many investors in these classes are unaware of their important rights to share in these recoveries. *The Wall Street Journal* reported on September 4, 2001 that "public and corporate pension plans are losing out on hundreds of millions of dollars in class-action settlements for which they are eligible simply by neglecting to file claims."

So, what is going on? Why are claims not being filed? One reason may be that, historically, many of these cases were settled for pennies on the dollar so many institutional investors seem to have concluded that having a process in place to make sure that claim forms were filled out and filed for covered losses in their portfolio was not important. That was probably a mistake — even years ago — before the passage in 1995 of the Private Securities Litigation Reform Act ("PSLRA"). There have always been large recoveries in many of these cases. Today, there is no question that very large sums are being generated by these cases and class members have a strong interest in making their claims. Indeed, a dismissive or cavalier attitude toward making sure that claim forms are filed could be an utter disaster for institutions with fiduciary or other responsibilities in this area.

To get a sense about the amount of money at issue, we reviewed the two largest cases that we prosecuted and resolved recently for our public retirement system clients, the *Cendant* case and the *3Com* case. In *3Com*, there are 75 claims in excess of $1 million and 350 claimants with claim amounts in excess of $200,000. We expect all claimants to receive approximately 50% of their claim amounts based on the $259 million recovered in the case. There are 30 public retirement systems in

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that group with the balance being corporate pension plans, foundations, mutual funds and other institutional investors. In *Cendant*, there are 100 claimants with claim amounts in excess of $10 million and 350 claimants with claim amounts in excess of $2 million. We expect the *Cendant* class members to also receive approximately 50% of their claim amounts. The *Cendant* claimants are a similar mix of institutional investors to *3Com*.

In short, you need to make sure that you have a system in place to timely file claims and the system you develop needs to respond to how the class action process works in the courts. You need to understand that identifying class members and getting claim forms filed is totally independent of the lead plaintiff process at the outset of the case. Your policy and approach to the lead plaintiff process should be independent of your need to manage the claim form process.

Pursuant to the PSLRA, any class member can move to be the lead plaintiff at the outset of a case. Institutional investors with large stakes in the outcome of the case, the paradigm investor envisioned under the PSLRA, are increasingly being appointed to this role. Once appointed, the lead plaintiff, through its counsel, prosecutes the case. The identity of the other class members is not formally determined at this time. There is no need and there is no preestablished process for class members to sign up for the case or sign up for the class at this time. It is left for a later point and class members do not lose their rights to participate in any eventual recovery. They need do nothing at this time.

The time to act comes when the case is resolved, usually between one and four years later. Thus, years after the wrong is committed and the case is started, the names of the class members — for example, the persons and entities that purchased the defendant company's stock during a specified period — must be reconstructed. When a securities class action is settled, counsel for the class will routinely obtain an order from the court to set a procedure to notify all

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Inside Look

The past few months have been difficult for everyone. The events of September 11 have affected all of us in different ways. Some, to be sure, have suffered greatly. As we gather with our families and friends this holiday season, our thoughts will be on those matters. With that in mind, I join with everyone at Bernstein Litowitz Berger & Grossmann to wish you happy holidays and the very best for the new year.

In this issue of the *Advocate*, Doug McKeige focuses on an important issue that affects all institutional investors, namely, how to get a share of class action settlements when you are a member of the class. According to *The Wall Street Journal*, public pension plans lose out on hundreds of millions of dollars because they fail to file claim forms when they are eligible to recover in settled class actions. There is no reason why this has to be the case. In *Leaving Money on The Table: Are You Collecting Your Claims?*, Doug demystifies the notification process and explains how institutions can recover money that is rightfully theirs by having the system's custodial bank monitor the settlements and notify the institution when it is entitled to recover from a settlement.

I also draw your attention to *Class Actions: Compensating Victims and Deterring Wrongdoing*. In that article, we take a step back and consider the social policies underpinning class actions, particularly in the case of open-market securities fraud. The critics of class litigation are vocal and hope for new laws to narrow the class device. But class actions are essential tools for compensating victims who would otherwise have no avenue for redress and also for deterring corporate wrongdoing. Given the recent spate of well-publicized accounting frauds and the ensuing recoveries through class litigation, the benefits of legitimate class actions to our capital markets cannot seriously be disputed.

In his *Eye On The Issues* column, Steve Mellen provides news and developments in the areas of securities and corporate governance. In this issue, Steve continues to monitor the SEC's transition from former Chairman Arthur Levitt to new Chairman Harvey Pitt, reporting that Pitt recently delivered a speech in which he told the accounting profession that he was not in favor of restatements and wished to avoid embarrassment to accountants. Shortly thereafter, news of Enron's wide-spread accounting improprieties broke. Unlike Pitt, Representative John Dingell criticized the apparent accounting failures that led to Enron's collapse and the need for immediate reform to the auditing system.

We hope that you enjoy reading this issue of the *Advocate*. We have enjoyed bringing it to you, and as always, I welcome all questions and feedback.

Max W. Berger

CLASS ACTIONS

COMPENSATING VICTIMS AND DETERRING WRONGDOING

A class action is a type of lawsuit where a representative prosecutes common claims of many, similarly-situated people. Thus, under appropriate circumstances, a court can efficiently resolve hundreds or even thousands of claims in a single action. This prevents piecemeal litigation and avoids inconsistent results.

Institutional investors, such as public pension funds, have a large stake in our capital markets and stand to benefit the most from the deterrence of corporate fraud.

The class device also gives individuals with relatively small losses, where the potential recovery does not justify the cost of an individual lawsuit, the ability to obtain redress by aggregating losses with others. These greater damages compel defendants to take notice. Class actions, therefore, promote the two fundamental purposes of the American tort system: Compensating victims and deterring harmful behavior.

A securities fraud lawsuit is a quintessential case for class treatment. When, for example, a company and its officers issues false or misleading information that artificially inflates the price of publicly-traded securities, each investor who purchased the security at inflated prices suffered an injury and has a potential claim. This can impact the retirement money and savings of many thousands of people and institutions, amounting in the aggregate to billions of dollars. Because each investor's claim arises from common facts, it makes common sense for an investor with a substantial stake in the lawsuit (or a small group of investors, in certain circumstances) to represent the entire class and sue to recover class-wide losses in a single lawsuit. Absent such a class action, most investors would have no practical avenue for redress. Moreover, because the aggregate damages are sometimes enormous, class actions have greater economic power and deter corporate wrongdoing far better than individual lawsuits.

Deterring corporate malfeasance is essential to the continued strength of our capital markets. Unquestionably, our securities markets are the safest and most efficient in the world. This is not an accident. After the stock market crash of 1929, investors lost confidence in the accuracy of corporate statements. To restore investor confidence, Congress created laws that require publicly-traded companies to make honest and timely disclosure of material information. We also have anti-fraud laws on the books that give private investors the ability to sue for damages when victimized by insider trading and similar schemes that undermine the market's strength and efficiency. Indeed, when enacting the Private Securities Litigations Reform Act of 1995 ("PSLRA") — which attempted to eliminate frivolous lawsuits — Congress reiterated that legitimate private actions are an "indispensable tool with which defrauded investors can recover their losses," "promote... confidence in our capital markets" and "help to deter wrongdoing."

Institutional investors, such as public pension funds, have a large stake in our capital markets and stand to benefit the most from the deterrence of corporate fraud. Institutional investors frequently have the largest financial interest in particular securities fraud class actions. As such, institutions are better able to maximize recoveries than investors with very small individual losses. Thus, when enacting the PSLRA, Congress sought to encourage institutional investors to take the lead in such cases. Since 1995, more and more institutions have stepped forward to represent the investor class in shareholder class actions. Consequently, the recoveries have been significantly higher than before the PSLRA. Since

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Quarterly Quote

"[T]he problem is not limited to Enron. There are likely other ticking time bombs out there with smoke-and-mirror earnings.... Our accounting and auditing system and its oversight are seriously broken and need immediate reform."

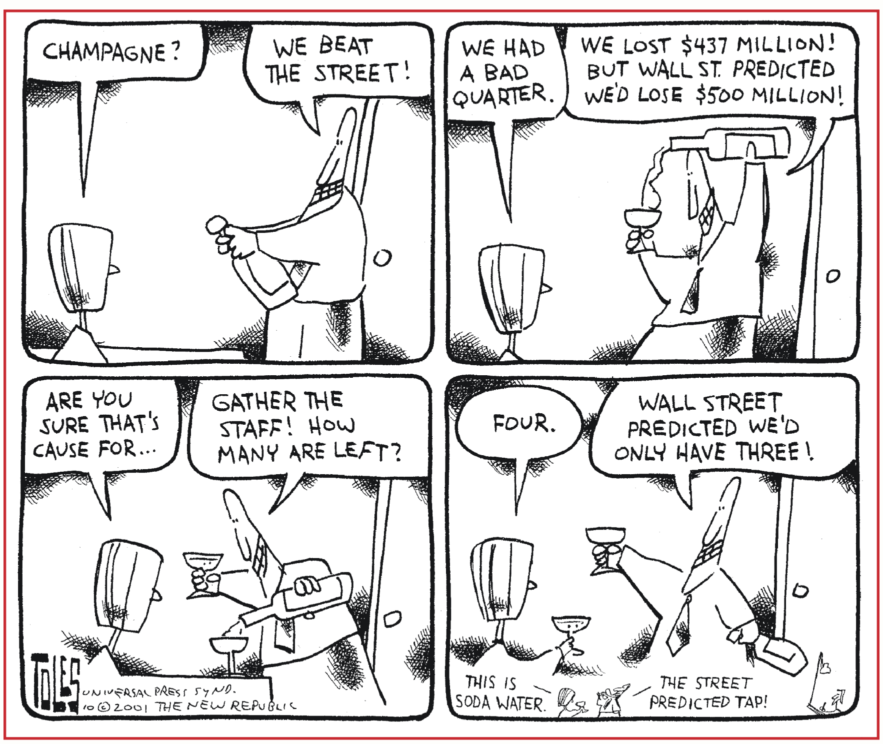
— Rep. John Dingell (D-Mich), addressing the recent collapse of Enron

Eye On The Issues

LEGISLATIVE/REGULATORY UPDATES
AND RECENT DECISIONS OF INTEREST

By Steven E. Mellen

What can we expect from the new SEC? As discussed in recent editions of the *Eye,* investors everywhere are watching the SEC closely to see if new Chairman Harvey Pitt will continue — or roll back — former chairman Arthur Levitt's well-publicized fight for investor protection measures. Early signs from the new administration are that the agency may be requiring fewer restatements of published financials, a step which often signals the presence of a major accounting fraud. Pitt has stated: "I am very much in favor of a vigorous enforcement program, but I am not in favor of having investors barraged by conflicting statements and restatements." Pitt may have summed up his view of his predecessor's philosophy in a recent speech to the American Institute of Certified Public Accountants: Henceforth, he said, "the commission will make sound decisions, in a respectful, affirmative way, not in a demeaning, demanding or demonizing way." It's clear that Pitt wants to protect auditors from public embarrassment what's not so clear is whether this goal can be accomplished consistently with protecting investors from accounting fraud. *Bloomberg News Service, October 26, 2001.*



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Save some insurance for the rest of us. When a company that has committed securities fraud goes bankrupt, often the only place shareholders can look for a recovery is the insurance policies which cover the officers and directors. However, these same insurance policies often pay for the costs of defending those officers and directors from suit — meaning that by the time their liability is established, the coverage has been exhausted. Judge William Alsup of the Northern District of California recently took bold steps in an attempt to address this problem, requesting in an order that defense counsel limit the number of attorneys and paralegals involved in depositions and "otherwise economize on timekeepers" in order to "avoid the recurring problem of defense counsel using up a large part of the insurance available for directors and officers' liability." Judge Alsup also indicated that, in cases where the insurance proceeds are largely exhausted, he may expect the individual officers and directors themselves to contribute financially to a settlement or establish their inability to pay. *In re Commtouch Software Ltd. Securities Litigation, Case No. 01-00719 (N.D. Cal.), September 10, 2001.*

What makes the SEC tick? Until recently, companies and investors could only speculate as to the reasons why the SEC chose to commence or not commence enforcement proceedings. The veil of mystery was lifted somewhat on October 23 of this year, when the SEC outlined in detail the reasons why it chose not to take action against Seaboard Corporation, which had published five years of false financials. The SEC cited the company's prompt action once its internal auditors learned of the misstatements, its timely dismissal of the responsible individuals, and its full cooperation with the SEC. In its published Report of Investigation, the SEC set forth thirteen criteria relevant to its determination of whether to bring enforcement proceedings, including the nature of the misconduct, the efforts made to uncover it, the extent of harm suffered by investors, and the steps taken to ensure that the conduct will not recur. Responding to criticism that the agency will be less diligent, the SEC's new director of enforcement, Stephen Cutler, says otherwise: "At the end of the day, the reason the SEC did this was to offer more protection for investors. It will bring in more cases and use fewer resources. It's not a softening of the SEC." *The National Law Journal, November 7, 2001.*

"Pro forma" over substance. One of the most popular ways for companies to paint a rosy picture in the face of adverse developments is through the publishing of "pro forma" financial statements. Pro forma financials are based not upon a company's actual financial performance, but on an assumed set of facts. All too often, companies simply use pro formas as a way to avoid reporting expenses that they don't want to talk about. And because every company uses pro formas in a different way, it becomes increasingly difficult for investors to compare profit numbers from different companies and determine whether those numbers are fact or fiction. The abuse of pro formas has become so prevalent that Standard & Poor's, which compiles the well-known S&P 500 stock index, has been forced to institute a push for industry standards to eliminate confusion. In a letter to top Wall Street executives, S&P urged a common definition of "operating earnings," a number which is often ascribed meaning by analysts even though it has as many different definitions as there are companies using it. S&P indicated that this was the first step in a broader push for uniformity in "pro forma" reporting, a welcome movement that will cut down on the spread of misleading information to investors and enable more informed investment decisions. *The Wall Street Journal, November 7, 2001.*

Plaintiffs and defendants seeing eye to eye. You might assume that defense lawyers are opposed to institutional investor participation in securities class actions, since the presence of an institutional investor often means a greater recovery for shareholders and more money out of the pockets of the companies these defense lawyers represent. But it's not always the case. In a recent thoughtful article entitled "The Fiduciary Duties of Institutional Investors in Securities Litigation," defense lawyers Craig C. Martin and Matthew H. Metcalf of Chicago's Jenner & Block argue strongly in favor of institutional investor participation in class actions, concluding that "the benefits of lead plaintiff status for institutional investors will often be overwhelming." *The Business Lawyer, August 2001.*

A new face at the SEC. Relatively little attention was given to the appointment of Alan Beller, a partner in the New York firm of Cleary, Gottlieb, Steen & Hamilton, as the new head of the SEC's corporate finance division. This is an important appointment for investors, however, because the corporate finance division is directly responsible for regulating communications between companies and investors and telling companies when they are required to make new informative disclosures with the SEC. Early indications are that Beller may institute new requirements obligating companies to tell the SEC and the public whenever their business experiences a significant material change that would be relevant to investors. This would represent a toughening of current requirements, which require such filings only under narrowly defined circumstances. The salutary result: More information for investors. *Law.com, November 21, 2001.*

NASDAQ suspends listing requirement. The tragic events of September 11 have made it even tougher for some struggling companies to stay afloat. In response, NASDAQ announced a waiver until 2002 of its regular listing requirements, which obligate a company to maintain a closing price of at least $1 a share. NASDAQ explained: "We did this because companies need to focus on running their business right now. It takes the distraction off the table for them." *The Wall Street Journal, September 28, 2001.*

Not all earnings disappointments are due to the September 11 attacks. Undoubtedly, the terrorist attacks have adversely affected almost all sectors of the economy. Unfortunately, it appears that under-performing companies may attempt to use the attacks as an excuse to explain poor results when those results were actually due to unrelated influences. For example, pharmaceutical maker Cambrex Corp. cut its earnings forecast for the third quarter by 14 cents per share, citing the adverse impact of the September 11 attacks. But after investors raised questions, the company was forced to admit that less than three cents of the shortfall had anything to do with orders that were cancelled as a result of the attacks. *The Wall Street Journal, October 5, 2001.*

Steve Mellen is an associate at BLB&G and can be reached at stevem@blbglaw.com.

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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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potential class members of the settlement. The notice includes a description of the case and the terms of the settlement and will include a claim form that usually must be completed and returned to a designated claims administrator to be filed within three to six months.

The process to make sure that class members receive adequate notice involves a couple of steps. Using stock transfer records, plaintiff's counsel and the claims administrator can start identifying class members and getting addresses. That data, however, is far from complete because 90% of stock is held in the "street name" of the broker, custodian or transfer agent on behalf of the beneficial owner of the securities. The claim form must go to the beneficial owner (or legal guardian or trustee of the beneficial owner) of the securities. The beneficial owner is the only party that can lawfully execute the claim form. Thus, the notice procedure also requires the claims administrator to place an advertisement of the settlement in *The Wall Street Journal* or *Investor's Business Daily*. Even more important, the claims administrator sends a copy of the notice and the court's order to the universe of approximately 3,000 brokers, custodians, nominees, banks and other entities requiring them to research their records for their clients that may have traded the subject security during the relevant time frame. The court's order requires the recipients to perform the relevant research. The brokers, custodians and others then are required to either provide the names of the beneficial owners to the claims administrator or directly forward the claim forms on to their clients.

To avoid missing out on proper notice and recovering available funds, public retirement systems should use their custodial banks or the equivalent of the custodial bank for other institutional investors (your prime broker for example). You may consider making this a responsibility in the custody agreement. However, our institutional clients currently rely on their custodial banks to perform this function whether or not it is a specified responsibility in the custody agreement. Some of the custodial banks are moving toward defining this as a separate service and seeking to be paid for it.

Why are claims not being filed? One reason may be that, historically, many of these cases were settled for pennies on the dollar… Today, there is no question that very large sums are being generated by these cases and class members have a strong interest in making their claims.

It is not practical or feasible to have a staff person at your firm or pension plan search for and review all class action settlement notices and cross reference all such notices against the trading in the relevant portfolio. There are a large number of cases being resolved and the necessary transaction information that must be set forth in the claim form often dates back many years. The data is usually not available at the offices of the pension plan and must be obtained from the custodian.

Rather, the best approach is to assign the custodian this responsibility and then require quarterly reporting to make sure that the job is being done. Their work can be periodically monitored and audited. The custodian should have all the necessary records. The custodian has a staff of people presumably qualified to do this work. The custodian should have dozens or hundreds of clients that require the service and enjoys the associated efficiencies.

Keep in mind, though, that most securities class action settlements and the class of investors represented are identified in a notice published in a national newspaper. You can monitor these notices in house and pass them along to your custodian or, alternatively, instruct your custodian to monitor these announcements.

As you explore this subject with your custodian or prime broker, a number of issues will come up. The contractual language describing the responsibility will need to be determined, and I can send proposed language to you. If you have an existing contract and the custodian is already doing the work, there may not be a need or a desire to amend the contract and pay additional charges. When the contract is up for renewal, the subject is likely to arise. One custodian has proposed to be paid a percentage of what is recovered, while others have proposed to be paid a flat amount or a charge per claim form. There does not appear to be a consensus approach on this point.

Many of our clients and friends in the institutional investor community have been largely focused on the lead plaintiff subject in recent years. However, getting claim forms filed correctly and in a timely manner also has a large financial impact on your firm or pension fund. The money is rightfully yours. I urge you, therefore, to take the time to establish a process to identify cases in which you can recover and properly file all claims.

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 Why do companies repeat the same language at the end of every press release, saying that the release contains "forward-looking statements" and that actual results may differ?

A Publicly-traded companies include that language in an attempt to get the protection of the "safe harbor" for forward-looking statements, which Congress created as part of the Private Securities Litigation Reform Act of 1995. Under certain circumstances, defendants in securities fraud lawsuits are protected from liability for false or misleading forward-looking statements. The safe harbor applies only to identified forward-looking statements (not statements of existing or historical fact) that are accompanied by "meaningful cautionary language."

Congress' stated purpose for enacting the statutory safe harbor was to allow companies to freely publicize their forecasts and projections without fear of investor lawsuits if the company falls short of expectations. In practice, however, companies routinely affix boilerplate "safe harbor warnings" to every press release and SEC filing, even those that are knowingly false or contain no forward-looking statements. If the company is later sued for misleading investors, defendants can attempt to invoke the safe harbor. The Reform Act, however, did not eliminate liability for knowingly misleading investors. Thus, adding generic language to each press release may give companies an argument that the safe harbor applies, but doing so does not automatically protect defendants from liability.

CLASS ACTIONS

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1997, more than $10 billion dollars has been recovered through settlement, which is a mean increase of more than $10 million per settlement. Because institutions are entitled to the largest *pro rata* share of these recoveries, the participation of institutional investors in shareholder class actions has paid off handsomely.

As the larger recoveries show, shareholder class actions remain an effective tool to compensate victims of securities fraud and deter corporate wrongdoing. The PSLRA, after all, may have raised significant hurdles for defrauded investors, but it did not erect insurmountable barriers to legitimate securities fraud lawsuits. Now, as before, securities-fraud cases are perfectly suited for class treatment and are vital to the protection of shareholder interests and the continued strength of our capital markets.

Contact Us

We at BLB&G welcome input from our readers. If you would like to comment on any of the articles in this newsletter, or have any suggestions for articles that may be of interest to you, please contact Editor David R. Stickney, at 858-793-0070 or by E-mail at davids@blbglaw.com. Questions for our INFORMED SOURCES question and answer column may also be submitted to David R. Stickney. If you would like more information about our firm, please visit our website at

www.blbglaw.com

Editor: David R. Stickney
Editorial Director: Alexander Coxe
Contributors: Max W. Berger, David R. Stickney, Douglas M. McKeige and Steven E. Mellen

BLB&G
BERNSTEIN LITOWITZ BERGER & GROSSMANN LLP

800-380-8496
E-mail: blbg@blbglaw.com

New York
1285 Avenue of the Americas
New York, New York 10019
Tel: 212-554-1400
Fax: 212-554-1444

California
12544 High Bluff Drive
San Diego, CA 92130
Tel: 858-793-0070
Fax: 858-793-0323

New Jersey
One University Plaza
Hackensack, NJ 07601
Tel: 201-487-9700
Fax: 201-487-7006

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hope and peace this holiday season