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Advocate

A SECURITIES FRAUD AND CORPORATE GOVERNANCE QUARTERLY

THE PLIGHT OF THE MINIMUM WAGE CEO

By Eric Kanefsky

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Americans have always been quick to lend their support to a worthy cause. Recently, a new cause has developed that you may not be aware of: the plight of the "Minimum Wage CEO." Minimum Wage CEOs are those men and women who run America's Fortune 500 companies while making paltry salaries of about seven million dollars. These executives have been grouped by association with their much higher paid peers and are now in danger of having their already minuscule wages further diminished. It appears, though, that their struggle will be short-lived. Despite the recent efforts of our judicial system, the SEC, and the investing public, these "under-paid" CEOs will likely escape unscathed from the recent crackdown on excessive executive compensation, which has been focused exclusively on the most egregious cases, rather than on the inherent flaws in how companies determine a CEO's compensation.

The Numbers — From Eugene E. Grace to Richard Grasso

According to *Forbes* magazine, in 2003, the CEOs of America's 500 largest companies received an aggregate 8% pay raise last year, earning total compensation of $3.3 billion, with the average compensation package worth $6.7 million. According to *Business Week,* the average CEO's pay has increased from 42 times that of the average production worker in 1982 to 411 times in 2001. A recent article in *Time* magazine regarding excessive executive compensation stated that the typical CEO now makes $301 for every $1 paid to the typical employee. That's up from $42 to $1 in 1982. (*See chart on page 5 for further analysis.*)

One possible reason for the increase may be that many of the Fortune 500 companies set their executive compensation based on what

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rival companies pay their top executives. A recent study by three finance academics found that the use of peer groups as a reference point for compensation decisions (so called "benchmarking") is a widespread practice. The study further concluded that the CEOs whose companies use benchmarking "receive significantly larger pay increases" after such peer group reviews take place. As Lalitha Naveen, an assistant professor at Georgia State University explained, "[i]f everybody wants to be at or above the median, the median has to increase over time." According to the study, the CEOs whose pay levels were below their peer group's median received larger increases, even though their firms exhibit statistically significantly worse accounting and stock-price performance relative to firms with CEOs whose pay is above the median. Professor Naveen concluded that "[i]t doesn't seem to matter how badly you've been performing."

Over-compensated CEOs, however, have been around since America first industrialized, and, despite recent events, they are most likely here to stay. Looking back, Eugene G. Grace, president of Bethlehem Steel in 1929, earned a $1.6 million cash bonus on a salary of just $12,000. As Stanford Business School Professor Maureen McNichols explained in a recent address to an alumni audience, Grace's bonus is "equivalent to a bonus of over a billion dollars on a million-dollar salary today." Four years later in 1933, irate shareholders filed the first known lawsuit regarding executive compensation against American Tobacco for its $1.3 million payment to company president George Washington Hill. In that case, the Supreme Court decided that pay at public companies could be subject to judicial review. One year later, the Securities and Exchange Commission ruled that shareholder proposals on executive pay and other governance issues should be included in proxies and voted on at annual meetings. While public disclosure of top executives' pay in proxies sheds some light on executive compensation, today's compensation packages are often so complex that, proxy disclosure notwithstanding, it is difficult to decipher the true worth of an executive's compensation. Frequently,

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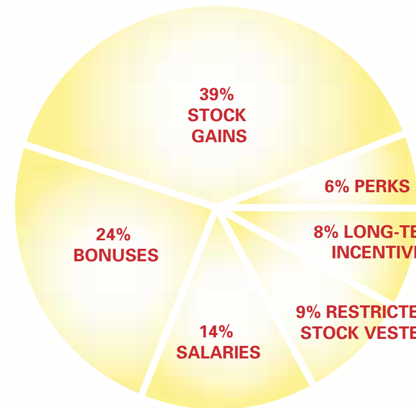
How CEOs were paid in 2003



The chief executives at the 500 largest U.S. companies made an average $6.7 million last year, most of it from exercising stock options and rising share prices. It's easy to hide a few million more. Compensation and perquisites deferred until after retirement don't appear in last year's averages.

Source: *Forbes*, May 10, 2004

Inside Look

This quarter, the *Advocate* focuses on two important issues concerning investors: continually rising executive compensation and the contribution institutional investors have made to recent securities litigation settlements. In "The Plight of the Minimum Wage CEO," Eric Kanefsky examines the phenomenon of Fortune 500 executives whose multimillion dollar salaries continue to escalate even in the wake of recent corporate scandals. As noted in the article, although many executive salaries often reach millions of dollars, they pale when compared to the hundred million dollar paychecks of Dick Grasso and the like, and thus avoid public scrutiny. The article also notes that, according to a recent study, executive compensation in most companies continues to be tied to what rival companies pay its executives rather than to the executive's actual performance.

In "The Results Are In…Class Action Settlements Are Significantly Higher When Institutional Investors Act as Lead Plaintiffs," Sean Coffey and John Browne discuss the growing involvement of institutional investors as lead plaintiffs in securities class actions. As noted in the article, a recent Cornerstone Research study found that the involvement of institutional investors in securities litigation leads directly to higher settlement amounts. The recent $2.65 billion settlement of *WorldCom Securities Litigation* with Citigroup, in which Lead Plaintiff the New York State Common Retirement Fund played a key role, is a perfect example of institutional investors' ability to deliver great results to the investing public. Sean's and John's article brings you the highlights of this groundbreaking settlement.

As usual, we also draw your attention to our regular *Eye on the Issues* column. As has been the case for quite a while now, we could fill the entire *Advocate* with news reports affecting securities and corporate law. In this issue, Tim DeLange, our *Eye on the Issues* correspondent, has again insightfully compiled the most significant developments in the field for your easy reference.

We hope that you will enjoy this issue of the *Advocate*. As always, we endeavor to make it worth reading and we welcome your comments, questions and input.

Max W. Berger

THE RESULTS ARE IN…

CLASS ACTION SETTLEMENTS ARE SIGNIFICANTLY HIGHER WHEN INSTITUTIONAL INVESTORS ACT AS LEAD PLAINTIFFS

By John P. ("Sean") Coffey and John C. Browne

Less than a decade ago, most institutional investors would have scoffed at a suggestion that they seek to be appointed as lead plaintiff in a securities class action lawsuit. For institutional investors, taking an active role in class-action litigation was procedurally difficult and economically questionable. The popular perception of securities class actions at the time was that they were "lawyer-driven" lawsuits with nominal "lead plaintiffs" who were appointed solely because their lawyers had won the infamous "race to the courthouse." In this environment, many institutional investors were of the view that seeking a role as a lead plaintiff would simply waste their time and resources without leading to a commensurate impact upon the final result. In short, institutional investors did not see how their involvement in a securities class action lawsuit was likely to increase the recovery to the class, and ultimately, to their defrauded investors.

In this article, we briefly recap the changing attitudes of institutional investors towards assuming the lead plaintiff role in securities class actions: from a hands-off to a decidedly hands-on approach. We also discuss a recent settlement of note that has been achieved by an institutional investor acting as lead plaintiff — the partial settlement of the *WorldCom Securities Litigation* with Citigroup for a cash payment of $2.65 billion. Finally, we review the results of a recent academic study, which found that the involvement of an institutional investor in a securities class action lawsuit directly leads to larger settlement amounts.

After the Cendant settlement, institutional investors started to take notice that the PSLRA gave them the tools necessary to make a real difference in large securities class actions.

Background

In December 1995, Congress tried to get institutional investors more involved in securities class actions by enacting the Private Securities Litigation Reform Act (the "PSLRA"). As discussed in the very first issue of the *Advocate,* Congress' primary intent in enacting the PSLRA was to ensure more effective representation of investors by taking control of shareholder litigation away from lawyers and placing it in the hands of substantial and sophisticated institutional investors who had the ability to exert control over their counsel. See "Institutional Investors As Lead Plaintiffs: Is There A New And Changing Landscape?," Volume 1, First Quarter, 1999, *Institutional Investor Advocate.*

Notwithstanding Congress' efforts, the initial response of institutional investors to the PSLRA was somewhat tepid. In 1997, the SEC noted that "Congress' efforts to encourage more active participation by institutional and other large investors has not yet taken hold…in the 105 cases filed in the first year after passage of the PSLRA, we have found only eight cases in which institutions have moved to become lead plaintiff." Thus, in the immediate aftermath of the

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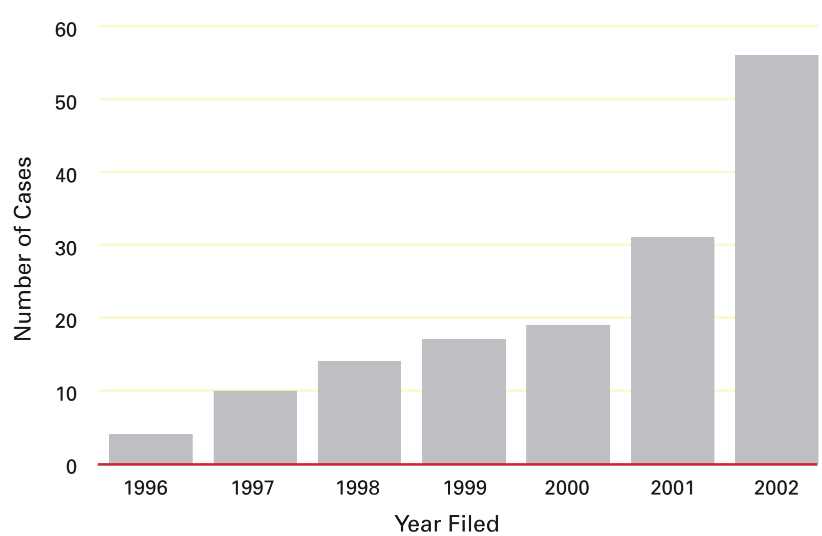
CASES WITH PUBLIC PENSION FUNDS AS LEAD PLAINTIFF*



*Includes state, city and union funds.

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actual salary makes up only a small percentage of CEO's compensation with the largest contributor being stock gains or retirement packages.

Recently, in the wake of massive corporate fraud scandals, the investing public has, yet again, turned its focus to how much their CEOs are getting paid. As evidenced by public uproar regarding the compensation of executives like Michael Ovitz, Dennis Kozlowski, and Jack Welch, the public does not appear to like what they are finding. Even the venerated New York Stock Exchange has been tarnished by the disclosures that its CEO, Richard Grasso, received $140 million in total compensation in 2003.

While public disclosure of top executives' pay in proxies sheds some light on executive compensation, today's compensation packages are often so complex that, proxy disclosure notwithstanding, it is difficult to decipher the true worth of an executive's compensation.

No More Mickey Mouse Operations

Two recent lawsuits involving Disney and the NYSE have put a new fear into directors everywhere and have forced them to reevaluate how they make decisions to hire and compensate executives. In making such decisions, directors have traditionally been protected by a legal doctrine known as the business judgment rule. Essentially, the business judgment rule shields directors from liability for all decisions made in good faith, due care, and within their authority. However, in May 2003, Delaware Vice Chancellor William B. Chandler sent shock waves through board rooms across the country when he ruled that a shareholder suit against Walt Disney Corporation and its board of directors could go forward. The facts surrounding the Disney litigation demonstrate that some courts may be fed up with boards that blindly approve excessive executive compensation packages.

This not-so-Disney tale began in the fall of 1996 when Michael Eisner, the chairman and CEO of Disney, decided that his company's newly hired president, Michael Ovitz, had to be let go. In the end, Ovitz walked away with a severance package worth approximately $140 million dollars for his fifteen months of service and Disney and its board of directors got hit with a shareholder lawsuit. In *In re The Walt Disney Company Derivative Litigation,* 825 A.2d 275, V.C. Chandler opined that, if the facts alleged were proven, they would establish that Disney's directors failed to make any good faith attempt to fulfill their fiduciary duties to Disney and its shareholders when they approved Ovitz's contract and again when they approved his severance package. The *Disney* complaint alleges that it was Eisner, a long-time friend of Ovitz, who unilaterally made the decision to hire Ovitz, that the directors allegedly spent less than an hour reviewing this decision, that they never reviewed the employment agreement or the specifics of Ovitz's compensation package, and that they never sought the advice of a compensation expert. The complaint further alleged that it was Eisner alone who decided to grant Ovitz the no-fault termination which resulted in Disney owing him a severance package worth approximately $140 million. The court stated that if all these facts were true, they "suggest that the defendant directors *consciously and intentionally disregarded their responsibilities,* adopting a 'we don't care about the risks' attitude concerning a material corporate decision." *Id.* at 289. (Emphasis added.)

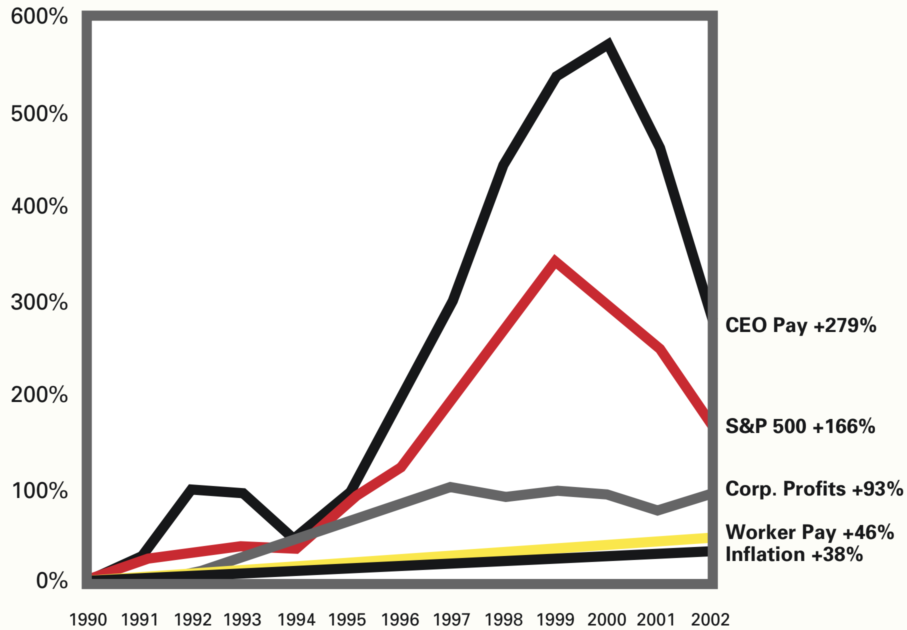
A year after the *Disney* decision, New York Attorney General Eliot Spitzer sued former New York Stock Exchange ("NYSE") Chief Executive Richard Grasso, seeking the return of at least $100 million from Grasso's controversial $188.5 million pay package. Spitzer's lawsuit also named as defendants Kenneth Langone, the NYSE Compensation Committee's former Chairman who played a role in the approval of the pay package and the exchange itself. Frank Ashen, the NYSE's former Executive Vice President, has already settled with Spitzer's office for $1.3 million for his role in Grasso's compensation package. Spitzer has called the process used by the Exchange to determine Grasso's compensation as "rigged" and "wholly inappropriate and illegal."

Not all courts, however, have been so quick to come between CEOs and their "hard earned" compensation. In early May 2004, a three-judge panel of the Ninth Circuit Court of Appeals vacated a federal district court ruling that allowed the Securities and Exchange Commission to block $37.6 million in severance payments owed to two former executives of Gemstar-TV Guide International, Inc. These decisions stem from Gemstar's October 2002 announcement that it would restate its financials from July 1999 through March 2002 and the SEC's subsequent investigation into the company's accounting practices. The issue before the Court of Appeals was whether those severance payments were "extraordinary payments" under Section 1103 of the Sarbanes-Oxley Act. Specifically, Section 1103 proscribes "extraordinary payments" to executives while a Company is the subject of a "lawful investigation involving possible violations of the Federal securities laws." The Ninth Circuit reversed the district court's decision to allow the SEC to keep the severance payments in escrow because "there [was] no evidence in the record of what similarly placed officers and board members of corporations of similar revenues and worth are paid upon termination." The Court went further to add that while "[s]uch payments may be called 'golden parachutes' or 'golden handshakes' in the press [this] purple prose is not enough to prove a statutory requirement in court." *Id.* at 1094. Apparently, the circuit court in *Gemstar* believed that $37.6 million in severance to two former executives was not, on its face, "extraordinary" in light of today's corporate culture of mega-compensation packages.

Fueled by unprecedented shareholder activism, which, in large part, contributed to the passing of the impending accounting changes that will require stock options to be expensed on income statements, the liberal use of stock option grants is slowly becoming a thing of the past.

The *Gemstar* decision notwithstanding, the corporate culture of mega-compensations appears to be slowly changing from within. Fueled by unprecedented shareholder activism, which, in large part, contributed to the passing of the impending accounting changes that will require stock options to be expensed on income statements, the liberal use of stock option grants is slowly becoming a thing of the past. The value of the stock option grants in 2003 decreased by 14%, and some companies, like corporate trend-setter Microsoft, have done away with stock option grants altogether. Shareholder activism also contributed to the SEC's latest proposal that will allow large shareholders to nominate their own board members. Even the New York Stock Exchange and NASDAQ now stipulate that corporate boards' compensation committees which approve executive compensation have to consist solely of independent directors.

CEO PAY, STOCK PRICES, CORPORATE PROFITS, WORKER PAY, AND INFLATION, 1990-2002



SOURCES: CEO Compensation: Business Week annual executive pay surveys. S&P 500 Index: Standard and Poors Corporation. Corporate Profits: Bureau of Economic Analysis, National Income and Disposition of Personal Income Data. Average Worker Pay: Bureau of Labor Statistics, "Average Weekly Earnings of Production Workers, Total Private Sector." Series ID: EEU00500004. Inflation: Bureau of Labor Statistics, Consumer Price Index, All Urban Consumers.

Effect on the Minimum Wage CEO

While it appears that, in the current environment, neither the courts nor the investing public are going to continue to let executives receive massive pay days, it is unlikely that the recent developments will have an effect on the Minimum Wage CEO. These CEOs are making far below what Ovitz, Grasso, or Welch were making, albeit very handsome amounts, and their paychecks are not large enough to generate sufficient interest. Thus, the Minimum Wage CEO will likely continue to benefit from the use of benchmarking by companies to set compensation rather than the proper focus which should be on the actual performance of the CEO. Moreover, as seen in the *Gemstar* case, courts may be reluctant to find that the Minimum Wage CEO's pay is unreasonable in light of the nine figure payouts that some executives have received. Even without judicial intervention, directors should now realize that there is a limit to executive compensation. Where this "limit" lies between about seven million and hundreds of millions of dollars is still anyone's guess.

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Eye On The Issues

LEGISLATIVE/REGULATORY UPDATES
AND RECENT DECISIONS OF INTEREST

By Timothy DeLange

Cable Guys Convicted of Securities Fraud. Adelphia Communications founder John Rigas and his son, Timothy Rigas, were convicted of deceiving investors and looting the cable company to pay for lavish lifestyles. After eight days of deliberations and nearly four months of testimony, the jury found Rigas and his son each guilty of 15 counts of securities fraud, two counts of bank fraud and a count of conspiracy. Both men face prison terms of as many as 30 years. The two men were found innocent of wire fraud. Another son, Michael Rigas, was acquitted of conspiracy and wire fraud, but the jury was undecided on securities fraud and bank fraud. The jury also acquitted former Adelphia Assistant Treasurer Michael Mulcahey of all charges. Prosecutors had accused the three Rigas men and Mulcahey of hiding $2.3 billion in debt. *CNN.com, July 8, 2004.*

Single E-mail Leads to Quattrone Conviction. Frank P. Quattrone, the former star banker who helped fuel the 1990's technology boom, was found guilty of trying to impede government investigations into how hot stock offerings were distributed to investors. The verdict came in a retrial after the first trial ended in a hung jury. Jurors quickly concluded that Quattrone attempted to hamper the criminal and regulatory investigations when he endorsed an e-mail message urging his staff of bankers at Credit Suisse First Boston to "clean up those files." Quattrone responded to the e-mail in question, "Having been a key witness in a securities litigation case in south Texas, I strongly advise you to follow these procedures." Quattrone sent the e-mail two days after being told about the grand jury probe and a few hours after being advised to hire his own lawyer to represent him. *Los Angeles Times, May 4, 2004.*

A Cry for Independence. In a hotly contested 3-2 vote, the Securities and Exchange Commission ("SEC") narrowly approved a rule requiring mutual fund companies to have independent chairmen. The new rule, which will take effect by the end of 2005, will displace sitting chairmen at approximately 80% of the nation's funds. SEC Chairman William Donaldson deemed the rule necessary to eliminate the "inherent" conflict in the fund industry. Under the current structure, the majority of fund chairmen are also executives of the investment advisor, which manages the fund's portfolios. This dual role presents a conflict of interest as the chairman is serving two masters — fund investors and the investment advisor. The new rule also requires that 75 percent of the directors be independent, up from 50 percent. *The Wall Street Journal, June 24, 2004.*

Show Me the Money. That is what investors in the scandal-ridden mutual fund industry are asking federal enforcers. Despite $1.4 billion worth of settlements from mutual and hedge fund managers since last September, not a single penny has been disbursed to injured investors. Why? First, only half — $700 million — of the total settlements have been collected. Canary Capital Partners, the first of the wave of settlements, has not paid its $40 million in penalties and restitution because the settlement hasn't been finalized. The same is true of a handful of other settlements, including the $515 million that Bank of America and FleetBoston Financial agreed to pay in March. Second, dividing up the pool of money involves a lot of complicated questions. Beyond the threshold question of who is owed money — current shareholders versus those who were invested at the time of the wrongdoing — there are other questions to answer, including identifying the victims, calculating their interest each time there was an illegal trade, and putting a total dollar amount on the illegal conduct. Finally, it is unclear who is responsible for distributing the money, the New York State Attorney General or the Securities and Exchange Commission. The New York Attorney General's office says it is up to the SEC to determine how and when the money gets distributed, but the SEC is not prepared to shoulder the entire burden. *CNN/Money, June 15, 2004.*

SEC Approves New Auditing Standard. The Public Company Accounting Oversight Board (PCAOB) announced that its Auditing Standard No. 2, "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements," has been approved by the Securities and Exchange Commission (SEC). Auditing Standard No. 2 addresses both the work that is required to audit internal control over financial reporting and the relationship of that audit to the audit of the financial statements. An audit of internal control includes, among other things, evaluating the process management used to perform its assessment of internal control effectiveness, evaluating the effectiveness of both the design and operation of the internal control, and forming an opinion about whether internal control over financial reporting is effective. "This standard is one of the most important and far-reaching auditing standards the Board will ever adopt," said PCAOB Chairman William J. McDonough. "In the past, internal controls were merely considered by auditors; now they will have to be tested and examined in detail." *AccountingWeb.com, June 21, 2004.*

Make the Numbers, Or Else. According to a survey of 179 finance executives conducted by *CFO* magazine this past March, the pressure to make the numbers look better has not subsided following the recent wave of corporate scandals. It remains alarmingly common for executives to lean on finance employees to "make the numbers work." Nearly half — 47 percent — reported they still feel pressure from their superiors to use aggressive accounting to make results look better. The finance executives identified personal greed, weak boards of directors, and overbearing CEOs as top causes for the scandals. What is worrisome is that the pressure to make the numbers has not abated. Of those who felt pressure in the past, only 38 percent feel less pressure today than three years ago, while 20 percent say there is more. Even more alarming, few finance executives expressed confidence in the numbers their colleagues are reporting. Only 27 percent say that, if they were investing their own money, they would feel "very confident" about the quality and completeness of information available about public companies. The rest were either "somewhat confident" or "not confident." *CFO.com, May 3, 2004.*

Banks Increase Pressure for Other Services. According to a recent survey of corporate-finance executives, banks are turning up the heat by conditioning loans on the purchase of other services. A whopping 96% of the finance executives who responded said they had been pressured to buy underwriting, merger advice and other services in exchange for loans. Almost two-thirds of the surveyed executives claimed a bank had denied credit or raised loan prices because the finance executive did not buy other services. Known as "tying," some attribute the rise in its use to the relentless banking-merger wave of the past two decades that has left much of the nation's lending capabilities in a few large commercial banks. The finance executives surveyed claim that tying has grown common in the five years since Congress repealed laws that separate the banking and brokerage business. While explicit quid pro quo arrangements that condition loans on buying other services have been illegal since the 1970s, tying can take on subtler forms that are not necessarily illegal, with banks telling customers that loans are just one aspect of a business relationship that needs more than loans to be worthwhile. *The Wall Street Journal, June 9, 2004.*

Coca-Cola Board Under Attack. As part of its ongoing fight to improve corporate governance, the California Public Employees' Retirement System ("CalPERS") announced that it would challenge more than half of the existing board of directors of Coca-Cola. CalPERS is questioning the objectivity of three board members, Herbert Allen, Donald Keough and Sam Nunn. Both Allen and Keough are officers in Allen & Co., an investment banking firm that advises Coca-Cola and its bottlers. Nunn, a former U.S. Senator, was a member of the company's law firm, which earned $13.8 million in legal fees from Coca-Cola. In addition, CalPERS has threatened to challenge the entire audit committee, including member Warren Buffett, for allowing the company's auditor, Ernst & Young, to perform "nonaudit services." Recently, however, CalPERS announced plans to re-evaluate its policy of automatically withholding support for directors who authorize corporate auditors to perform nonaudit work. *Fool.com, April 13, 2004; The Wall Street Journal, June 28, 2004.*

Big Board Considers Expansion of Automatic Execution Plan. The New York Stock Exchange ("NYSE") is considering a plan which allows investors to execute more stock orders automatically — a move likely to reduce the role of floor brokers. The plan would allow investors to execute orders automatically at as much as five cents above or below best price, a practice known as "sweeping." Large institutional investors favor the plan because they view the NYSE's dependency on brokers yelling out prices to "specialists" as slow and inefficient. Floor brokers oppose the proposal because they contend it would cut into their business and cause price swings that hurt investors and companies. The new plan expands upon an earlier NYSE proposal which permits buy and sell orders of any size to be electronically matched so long as the price of the stock is at its "best price." Current rules permit such automatic executions only of small stock orders, leaving the larger orders to specialists. *The Wall Street Journal, June 22, 2004.*

To Expense or Not to Expense? After intense lobbying by venture capitalists and high-tech corporations, the House of Representatives voted to squash an accounting rule proposed by the Financial Accounting Standards Board ("FASB"). The proposed FASB rule, which closely resembles accounting treatments used in Canada and Europe and by 120 of America's top 500 companies, would require that employee stock options be treated like any other form of compensation: as an expense reported in corporate income statements. According to 312 House members, however, companies should only account for the cost of options given to the top five executives; the options should be valued according to a formula that presumes stock prices aren't volatile; and there should be no accounting at all during the first three years after a company goes public. *Washington Post, July 22, 2004.*

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Quarterly Quote

"The money power preys upon the nation in times of peace and conspires against it in times of adversity. It is more despotic than monarchy, more insolent than autocracy, more selfish than bureaucracy. I see in the near future a crisis approaching that unnerves me and causes me to tremble for the safety of my country. Corporations have been enthroned, an era of corruption in high places will follow, and the money-power of the country will endeavor to prolong its reign by working upon the prejudices of the people until the wealth is aggregated in a few hands and the Republic is destroyed."

Attributed to President Abraham Lincoln in a November 21, 1864 letter to Colonel William F. Elkins

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PSLRA's passage, it appeared that institutional investors, who had not traditionally participated in securities class action lawsuits, were still not convinced that seeking a role as lead plaintiff could impact the bottom line: recoveries to their investors.

Attitudes Begin To Change

The pivotal moment when institutional investors began to change their attitudes towards taking an active role in securities class actions can be traced to the April 15, 1998 announcement by Cendant Corporation that its corporate predecessor had engaged in a massive accounting fraud. That announcement sent Cendant's shares plummeting by 47% and caused a $14 billion drop in its market capitalization. Damages to shareholders were estimated at approximately $7 billion. The three largest public pension funds in America decided to take action. The California Public Employees' Retirement System ("CalPERS"), the New York State Common Retirement Fund ("NYSCRF") and the New York City Pension Funds formed a group and were appointed as Lead Plaintiff (the "Lead Plaintiff Group"). The Lead Plaintiff Group, along with their counsel, Bernstein Litowitz Berger & Grossmann LLP and Barrack Rodos & Bacine, set about prosecuting the case. The result: approximately one year after the appointment of these institutional investors as lead plaintiff, defendants agreed to an unprecedented cash settlement of more than $3.2 billion, with approximately $2.8 billion coming from the company, and most of the remainder from the company's outside auditors. This settlement was more than four times larger than the largest previous settlement in the history of securities class actions, and ultimately resulted in a recovery to Class Members of approximately 40% of their damages.

After the *Cendant* settlement, institutional investors started to take notice that the PSLRA gave them the tools necessary to make a real difference in large securities class actions. A recent study prepared by PriceWaterhouseCoopers noted that "following *Cendant*, public pension funds have been more inclined to seek lead plaintiff appointments." (*Securities Litigation Update — the Pension Fund Factor,* Steven Skalak and Daniel Dooley.) Indeed, this study found that more than 55 cases filed in 2002 had a public pension fund as a lead plaintiff, as compared with only 10 in 1997. This increase occurred in large part because the *Cendant* settlement made it clear to institutional investors that their ability to identify and oversee experienced class counsel, coupled with the deference often shown by Courts to large public pension funds, allowed them to make a real difference in the outcome of securities class actions.

WorldCom: A Landmark Settlement, And Not Finished Yet

The latest example of the correlation between institutional investor involvement as lead plaintiff and settlement size is found in the recent partial settlement of the *WorldCom Securities Litigation.* On June 25, 2002, WorldCom, then the second largest telecommunications company in the world, shocked the investing community with the first of a series of disclosures that would eventually reveal that WorldCom's publicly reported earnings for 1999, 2000, 2001, and early 2002 had been overstated by an almost unfathomable $11 billion. WorldCom's disclosure of this massive fraud occurred shortly after it had conducted two of the largest public bond offerings in United States history: its May 2001 offering of approximately $12 billion worth of bonds and its May 2000 offering of approximately $5 billion in bonds. Soon after disclosing that the majority of its financial results from 1999 through 2002 were achieved through a massive fraud, WorldCom sought the shelter of bankruptcy, leaving investors in WorldCom's bonds and stock holding the bag on billions and billions on dollars in losses.

The NYSCRF, which suffered more than $300 million in losses from its purchases of WorldCom securities, was appointed Lead Plaintiff for the consolidated

WorldCom-related securities class actions pending in the Southern District of New York. At the direction of the NYSCRF, Co-Lead Counsel for the class, Bernstein Litowitz Berger & Grossmann LLP and Barrack Rodos & Bacine, undertook an exhaustive investigation into the WorldCom fraud and uncovered key facts which had not been revealed despite in-depth investigations being conducted by the New York State Attorney General's office and the SEC.

On May 10, 2004, after eighteen months of intense litigation effort, defendant Citigroup agreed to pay $2.65 billion in cash to settle the claims asserted against it in the securities litigation. This landmark and unprecedented settlement was achieved in large part due to the intense involvement of representatives of the NYSCRF, including the personal efforts of New York State Comptroller Alan G. Hevesi, who participated in several face-to-face negotiating sessions with the highest-ranking representatives of Citigroup. In announcing the settlement, Comptroller Hevesi stated: "With this settlement, we have gained an extraordinary recovery for WorldCom bondholders and stockholders... This settlement should serve as a wake-up call to those on whom the investing public depends to guard against corporate corruption such as occurred at WorldCom."

The cash payment of $2.65 billion is the second largest payment in securities class action history and, importantly, represents the largest amount — by far — ever recovered in a securities class action from a party other than the company that issued the securities. The vast majority — approximately $2.8 billion — of the *Cendant* settlement was funded by the company itself. The reaction in the investment banking community — where "gatekeepers" such as Citigroup routinely escaped serious consequences from their lucrative relationships with fraud-ridden corporations — was one of astonishment and denial. The reaction among the investing public, however, was quite different. As a *New York*

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THE SUPREME COURT TO ADDRESS LOSS CAUSATION

In an extraordinarily important development affecting securities litigation, on June 28, 2004, the Supreme Court agreed to review the Ninth Circuit's ruling regarding loss causation in *Broudo v. Dura Pharmaceuticals, Inc.,* 339 F.3d 933 (9th Cir. 2003). To recover under Section 10(b) of the Securities Exchange Act of 1934, investors must allege (and later prove) loss causation, i.e., that defendants' fraud caused investors' loss. In *Broudo,* the Ninth Circuit reaffirmed its longstanding rule that in a fraud-on-the-market case, "loss causation does not require pleading a stock price drop following a corrective disclosure . . . it merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause." *Id.* at 938. Other courts are less favorable to plaintiffs on this issue and require investors to show that a specific disclosure of fraud caused the securities' price to drop.

After losing in the Ninth Circuit, defendants and some activists in the securities industry want the Supreme Court to establish a rigid rule that defrauded investors can recover only by pointing to a truthful disclosure that drives down the securities' price on the last day of the class period, and that investors' recoverable loss is limited to this drop. Under such a rule, investors' ability to recover would be severely limited. In cases where a truthful disclosure ends the Class Period, such disclosure frequently comes after the company's stock has already collapsed and is close to worthless. Consequently, eventual disclosure of the truth has little impact on a securities price.

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Times editorial put it: "ensuring that banks, lawyers and accountants who are implicated in corporate fraud pay heavily for their misdeeds is an important step toward restoring confidence in the integrity of the marketplace." But perhaps Comptroller Hevesi put it best when he said that defendants such as Citigroup "are the gatekeepers, they have the obligation to present the most accurate picture for investors." The partial settlement with Citigroup proves that, by taking an active role as lead plaintiff in securities class action litigations, institutional investors can help make sure that all corporate constituencies — including gatekeepers — fulfill their obligations to investors.

It should be noted, however, that the *WorldCom* litigation is not over, and the work of the NYSCRF is not finished. The litigation is continuing against seventeen other investment banks that underwrote WorldCom's bond offerings, as well as Arthur Andersen and WorldCom's former directors and senior officers. Comptroller Hevesi has made clear that the size of the settlement with Citigroup will not lessen the NYSCRF's litigation efforts against the remaining defendants, vowing to "continue to pursue our claims against the others who bear responsibility for the debacle at WorldCom."

What The Research Shows

Institutional investors are within their rights to ask whether the "mega settlements" achieved in *WorldCom* and *Cendant* are simply outliers, or are they part of a larger trend where institutional investors acting as Lead Plaintiffs have positively impacted the size of class action settlements? A new independent study conducted by Cornerstone Research provides an answer. After a detailed review of all settlements reached in securities class actions since the enactment of the PSLRA through the end of 2003 (but excluding the partial *WorldCom* settlement), Cornerstone Research concluded that "settlement amounts are higher for cases in which an institutional investor serves as lead plaintiff." (*Post-Reform Act Securities Lawsuits, Settlements Reported Through December 2003,* page 9, Cornerstone Research, Laura E. Simmons and Ellen M. Ryan.) This conclusion is no statistical anomaly. The same study notes that in the years from 1996 through 2003, the average settlement size of securities class actions was higher in every year for cases where an institutional investor was a lead plaintiff. Indeed, averaging all settlements from 1996 through 2003, Cornerstone Research concluded that settlement amounts were twice as high in cases where institutional investors were lead plaintiffs. Cornerstone Research's important study provides compelling statistical evidence that Congress' intent in passing the PSLRA — to get institutional investors actively involved in the class action process so as to increase the recoveries to shareholders — was, in a manner of speaking, right on the money.

Cornerstone Research's study also shows that the changing attitudes among institutional investors with respect to seeking a lead plaintiff role in securities class actions are more than justified. There can be no doubt that by obtaining significant recoveries from those who participate in fraud, or from those who shirk their responsibilities while fraud occurs under their very noses, securities class actions directed by institutional investors can change the way that corporate America does business in the long run. In the meantime, securities class actions directed by institutional investors can significantly increase the recoveries to defrauded investors. As more institutional investors get involved in the class action process, there is no doubt that the trend identified by Cornerstone Research will only increase, and the benefits to defrauded investors, and to the capital markets generally, will continue to grow over time.

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