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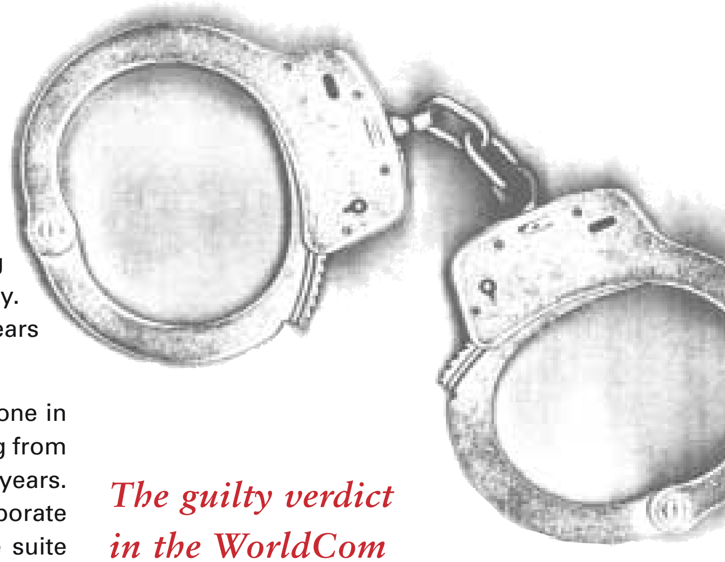
INSTITUTIONAL INVESTOR

Advocate

A SECURITIES FRAUD AND CORPORATE GOVERNANCE QUARTERLY

THE (HARD) TIMES THEY ARE A CHANGIN'

By David Kleinbard



On March 15, the boom fell down on former WorldCom Chief Executive Bernard Ebbers. After eight days of deliberation, a jury of seven women and five men found Ebbers guilty of all nine counts against him related to the $11 billion accounting fraud at the telecommunications company. Ebbers, 63 years old, is facing up to 85 years in prison.

The *Ebbers* jury's decision marks a milestone in a wave of criminal prosecutions stemming from corporate malfeasance over the past four years. Since 2001, scandals have swept Corporate America and corruption in the executive suite has been a hot political issue. Congress and federal agencies have responded with tougher treatment of those who rob with a fountain pen rather than with a gun. Federal prosecutors are more likely to pursue white collar offenders instead of allowing them to face only civil penalties from the Securities and Exchange Commission.

Prosecutors are more reluctant to offer lenient plea bargains to those at the top of the pyramid, and they are using the threat of long prison sentences to extract guilty pleas from mid-level executives at companies where accounting fraud was rampant. These mid-level players have agreed to testify against their former bosses in exchange for more lenient sentencing. The highest ranking executives—including WorldCom's Ebbers, Enron's Kenneth Lay and HealthSouth's Richard Scrushy—have claimed ignorance. These former CEOs claim that they were duped by subordinates who kept them in the dark about accounting chicanery.

The guilty verdict in the *WorldCom* case shows that juries aren't buying the "I was ignorant" excuse. Between 1997 and 2000, Ebbers collected more than $45 million in salary and bonus alone. The jury appears to have concluded that a person at that pay level should have a comprehensive understanding about his company's financial and operational condition.

The guilty verdict in the WorldCom case shows that juries aren't buying the "I was ignorant" excuse.

Still, white-collar criminal cases remain notoriously difficult to pursue. They involve complex accounting issues and many events taking place over a series of years. Often, there is no hard evidence tying the CEO or CFO to the fraud. In addition, the executives now on trial can afford to pay for expensive defense lawyers who will work around the clock to keep their clients out of prison.

"Accounting involves a lot of judgments, and there are numerous day-to-day decisions. It doesn't happen all at once like a robbery or a murder," said Peter Henning, a law professor

Continued on page 2.

(HARD) TIMES…

Continued from page 1.

at Wayne State University with expertise in white-collar crime. "These cases of accounting fraud are much more about judgment than insider trading cases are."

Because executives usually are smart enough to leave no written trail of evidence connecting them to a fraud, criminal cases against them often have to rely on ambiguous statements and the testimony of former underlings who already have pled guilty to a securities violation.

"Very rarely do people write a memo to file that says "commit the following fraud,'" said Wayne State's Henning. "These cases are based on ambiguities. It is very rare to have that smoking gun."

In the trial of WorldCom's Ebbers, for example, prosecutors alleged that when Ebbers told Chief Financial Officer Scott Sullivan "We have to hit the numbers," he actually was instructing Sullivan to commit fraud. Prosecutors were able to win the case against Ebbers even though they had no documents linking him directly to the fraud and they relied heavily on the testimony of Sullivan, whose credibility came under fire during the trial.

Enron's Collapse Leads to Stiffer Penalties

The collapse of Houston-based Enron in late 2001 created much of the impetus for tougher treatment of white-collar criminals. Within the space of 18 months, Enron went from a juggernaut trading near $90 a share, with revenue of more than $100 billion, to a bankrupt company with a stock price in the pennies. The energy company's abrupt collapse wiped out $66 billion in market value. Enron executives cashed out more than $1 billion in company stock while ordinary employees were barred from selling it from their Enron-heavy 401(k) accounts.

Even before Sarbanes-Oxley, there was a shift towards tougher sentencing of white-collar offenders.

After holding an extensive series of hearings on Enron's collapse, Congress responded by drafting what became known as the Sarbanes-Oxley Act of 2002. Just as Congress was finishing its work on the new law, WorldCom's audit committee disclosed that it had uncovered $3.8 billion in expenses improperly booked as capital expenditures, a gimmick that boosted cash flow and profit in 2001 and 2002. By April 2003, the estimated fraud at WorldCom rose to $11 billion.

Inside Look

This quarter, as a follow-up to Professor Norman S. Poser's well-received article, "The Origins of the Securities Laws," the *Advocate* provides an intriguing look into the recent trends in both the criminal and civil prosecution of securities fraud. In "The (Hard) Times They Are a Changin,'" David Kleinbard provides a timely and in-depth analysis of the recent high-profile criminal prosecutions stemming from the corporate malfeasance of the past four years. As David explains, the penalties now facing high level corporate executives for their involvement in the scandals that have swept corporate America have increased with the new federal sentencing guidelines and the increased activism of federal prosecutors.

While the guilty verdict against Bernard Ebbers sent a strong message that jurors are unwilling to accept the "I was ignorant" excuse from a company's top level executive, several high profile trials remain. As "The (Hard) Times They Are a Changin'" details, white-collar criminal cases remain difficult to pursue and often involve complex issues taking place over the course of several years. As we await the trials and verdicts in these remaining high-profile cases, we are pleased to bring you David's insight and analysis on this hot topic.

In "Beyond Criminal Prosecutions: Making the Gatekeepers Do Their Jobs," Tim DeLange analyzes the increased civil penalties being levied against the so-called "gatekeepers" of corporate America. From the outside directors and underwriters in *WorldCom*, to auditors and the first in-house counsel charged under the Sarbanes-Oxley Act, Tim explains how the "gatekeepers" are being pushed to bear much higher personal costs for their failure to adequately protect the investing public.

We invite you to stay tuned for the next edition of the *Advocate* where we will analyze how one court has changed the duties of America's "gatekeepers," and how one institutional investor has increased the due diligence being undertaken by these "gatekeepers."

We also direct your gaze toward our regular "Eye on the Issues" column. As usual, we could fill the entire *Advocate* with news reports affecting securities and corporate law. This quarter, Benjamin Galdston, our "Eye on the Issues" correspondent, has yet again provided an insightful compilation of the most significant developments in the field for your easy reference.

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

Max W. Berger

The Sarbanes-Oxley law took aim at corporate executives who falsify financial statements and at "gatekeepers," such as accountants and research analysts, who engage in conflicts of interest or fail in their fiduciary duties to shareholders. Several sections of Sarbanes-Oxley significantly increased the penalties for corporate fraud and other serious white-collar offenses (see chart, below).

Even before Sarbanes-Oxley, there was a shift towards tougher sentencing of white-collar offenders. In April 2001, the U.S. Sentencing Commission issued guidelines that increased the penalties for high-dollar frauds or thefts and reduced "unwarranted sentencing disparity." The guidelines issued in 2001 called for people convicted of insider trading, tax crimes or fraud in excess of $1 million to face a maximum of 63 months in prison.

In January 2003, the Sentencing Commission used authority granted by the Sarbanes-Oxley Act to once again significantly increase penalties for corporate fraud and other serious white-collar offenses. The new sentencing guidelines boosted penalties for white-collar offenses that "affect a large number of victims or endanger the solvency or financial security of publicly traded corporations, other large employers, or 100 individual victims." Under the new sentencing rules, an officer of a publicly traded corporation who defrauds more than 250 employees or investors of more than $1 million will receive a sentence of more than 10 years in prison (121-151 months), almost double the term of imprisonment previously provided. The Sentencing Commission also voted to increase penalties significantly for offenders who obstruct justice by destroying documents or records.

On January 12, the Supreme Court ruled in two 5-4 decisions that federal sentencing guidelines are unconstitutional because they violate a defendant's Sixth Amendment right to be tried by a jury. The court's two decisions on the matter gave broader discretion to federal

Continued on page 8.

Former WorldCom CEO Bernard Ebbers under arrest.

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Sarbanes-Oxley Provisions Designed to Curb Corporate Fraud

- ✔ Increased the maximum penalty for mail and wire fraud from five years to 20 years;
- ✔ Made it a crime to tamper with a record or otherwise impede any official proceeding;
- ✔ Gave the SEC the authority to seek court freeze of extraordinary payments to officers and directors;
- ✔ Instructed the U.S. Sentencing Commission to review sentencing guidelines for securities and accounting fraud;
- ✔ Allowed the SEC to prohibit anyone convicted of securities fraud from being an officer or director of any publicly traded company;
- ✔ Increased the SEC's funding to $776 million in 2003, versus about $440 million in 2002.

Source: Summary of Sarbanes-Oxley Act of 2002, American Institute of Certified Public Accountants

BEYOND CRIMINAL PROSECUTIONS: MAKING THE "GATEKEEPERS" DO THEIR JOBS

By Timothy DeLange

Beyond the criminal crackdown and increased sentencing guidelines, a new system of checks and balances has awakened, holding the "gatekeepers" of our capital markets — outside directors, auditors and underwriters — more accountable when a fraud is perpetrated by corporate insiders. As demonstrated by the directors' and underwriters' recent settlements in *WorldCom*, the trial of the Disney directors, and the quick ouster of AIG Chairman and CEO Maurice Greenberg, to cite just a few examples, institutional investors are focusing on the accountability of the corporate "gatekeepers" more now than ever before. In addition to Enron and WorldCom, there is a long list of recent, high-profile public company debacles, including AIG, Adelphia, Tyco and Hollinger, to name a few, which have reinforced the belief that the so-called "gatekeepers" of public companies too often are not performing their oversight function and have not been sufficiently incentivized to do so. Now, however, they are increasingly being faced with the reality of having to dig into their own pockets for their failure to protect the investing public, and it is making a significant and positive difference for investors.

In WorldCom, *the 11 former directors will dig into their own pockets to fund $24.75 million of the total settlement, or slightly more than 20 percent of the directors' combined net worth!*

"O.K.—let's review what you didn't know and when you didn't know it."

For example, on a single day in January, the face of liability for outside directors was changed dramatically. On January 7, 2005, the New York State Common Retirement Fund, lead plaintiff in the *WorldCom* class-action, announced an historic settlement where the former directors of WorldCom will personally pay millions of dollars. Thus, in *WorldCom*, the 11 former directors will dig into their own pockets to fund $24.75 million of the total settlement, or slightly more than 20 percent of the directors' combined net worth!

Historically, it was virtually unheard of for outside directors to pay personally to settle a securities fraud class action. According to a preliminary review conducted by a professor at Stanford Law School, from 1968 through 2003 directors contributed to a settlement out of their own pockets only four times — and those were minimal payments. This groundbreaking settlement highlights a new chapter in the backlash against corporate malfeasance in which the "gatekeepers" are being pushed to bear much higher personal costs for failures in supervision.

The fallout from the *WorldCom* settlement was immediate. Within days of the announcement of the settlement, several of the largest and most prominent securities defense firms responded with memorandums to their corporate clients addressing the implications of the settlement and providing guidelines and suggestions for countering the potential impact of this historic settlement. Among the suggestions and advice offered to boards and individual directors was: (i) keep informed of all corporate developments and be active and attentive, dedicating the time necessary to prepare for and participate fully in all meetings; (ii) carefully review any transactions involving management participation; (iii) keep a close eye on the ethics and integrity of management and use the assistance of outside counsel, accountants and other experts who are advising the company on critical issues; and (iv) review the company's D&O insurance, including separate "Side-A" insurance covering the directors separate and apart from the corporation. Such coverage is especially important should the company file for bankruptcy, as happened in both *Enron* and *WorldCom*. Indeed, just last month, Merrill Lynch & Co., the world's largest securities firm with capital of $199 billion, revealed a new type of insurance to protect its directors, executives and employees from delving into their own pockets should the company go bankrupt. Last year, Merrill established a "credit-default" agreement that would pay as much as $140 million to a trust in the event Merrill becomes insolvent. The trust would use the money to reimburse directors and employees for any personal loss stemming from legal claims. Although Merrill already has traditional directors' and officers' liability insurance, the credit-default arrangement will provide additional liability protection.

While companies are busily trying to insulate their directors from personal liability, one could reasonably ask — aren't the suggestions above what outside directors should be doing in the normal course of their duties? Why should it have been necessary for this unprecedented settlement to serve as a wake-up call to outside directors to do what they should be doing all along — and are getting paid handsomely to do at that?

The two-month *Disney* trial — now completed and awaiting a decision from Delaware Court of Chancery Judge William Chandler III — demonstrates just how far the latest phase of corporate accountability has progressed. At trial, plaintiffs focused on how the Disney Board of Directors allowed shareholder money to be used to pay Michael Ovitz's $140 million cash and stock severance after barely a year of service as President. At issue is whether the directors honestly and in good faith believed they were acting in the best interests of the shareholders when they rubber-stamped the pay and severance package of Ovitz by his close friend, former Disney CEO Michael Eisner.

Quarterly Quote

"One can't overlook the costs of the sort of corporate malfeasance we have seen in the last several years — not just in market cap declines, eviscerated pensions and lost savings, but in diminished investor confidence and a loss of faith in the integrity of our markets. The notion that we should turn back the clock and ease up on our enforcement efforts is sorely misguided."

In a March 18, 2005 speech at Duke University, outgoing SEC Enforcement Chief Stephen Cutler, defending his tough approach to enforcement and responding to ongoing lobbying efforts by the business community to get the Commission to ease up on its crackdown on corporate fraud.

The increased activism towards the accountability of outside directors is not limited to institutional investors…Indeed, the SEC — often criticized for having missed large problems in the past — has been moving faster and more aggressively when cases arise.

The increased activism towards the accountability of outside directors is not limited to institutional investors, such as those who are leading the *Enron* and *WorldCom* cases. Stephen Cutler, Director of the SEC's Division of Enforcement, warned in a September 2004 speech, "Over the next year, we intend to continue focusing closely in our investigations on whether outside directors have lived up to their roles as guardians of the shareholders they serve." Indeed, the SEC — often criticized for having missed large problems in the past — has been moving faster and more aggressively when cases arise. Asset freezes, lifetime bars preventing individuals from serving as corporate officers and directors, and financial sanctions all reached record levels last year, according to SEC data.

For example, in September of last year, the SEC announced a settlement with Electro Scientific Industries general counsel John Isselmann, Jr., who became the first company lawyer to be penalized for "gatekeeper" violations under the Sarbanes-Oxley Act. According to the SEC, "he had information that he should have passed on to the board and the company's external independent auditor. If that information had been presented, it would have prevented the financial fraud." Under the settlement, Isselmann will pay a $50,000 civil penalty and refrain from service as an officer or director of any public company. In addition, KPMG LLP recently agreed to a settlement in connection with its role in the Gemstar-TV Guide accounting fraud that includes a censure and $10 million payment to

Continued on page 11.

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Eye On The Issues

LEGISLATIVE/REGULATORY UPDATES
AND RECENT DECISIONS OF INTEREST

By Benjamin Galdston

Over $6 Billion Recovered So Far In Record WorldCom Settlements. After four weeks of trial, on April 25, 2005, former "Big Five" accounting firm and sole remaining defendant in the *WorldCom Securities Litigation* Arthur Andersen agreed to pay $65 million to settle all claims against it. Combined settlements in the *WorldCom Securities Litigation* surpassed $6 billion after investment banker J.P. Morgan Chase & Co. agreed to pay $2 billion on the eve of trial. J.P. Morgan was the last of seventeen investment banks involved in the 2000 and 2001 WorldCom bond offerings to settle with the Lead Plaintiff, the New York State Common Retirement Fund. The Judge presiding over the case quickly granted preliminary approval of the J.P. Morgan settlement. The *WorldCom* settlements double the previous record for a securities fraud case set in *In re Cendant Corporation Securities Litigation,* which settled for $3.1 billion. The settlements mark a historic victory for shareholders for several reasons, aside from the record amount. For the first time, the Lead Plaintiff insisted that the outside directors of WorldCom pay from their own pockets rather than relying on insurance to settle claims against them. The directors collectively paid over 20% of their personal net worth toward the settlement. Also, the settlements will undoubtedly have a profound effect on the way investment banks underwrite new securities offerings. Trade groups are already discussing proposals to adopt formal due diligence guidelines and other compliance measures to safeguard against liability for fraud among their clients. *Bloomberg News, March 18, 2005; Wall Street Journal, April 7, 2005; The New York Times, April 25, 2005.*

First New Federal Law of 2005 — Class Action Fairness Act. On February 18, 2005, President Bush signed the Class Action Reform Act into law, calling the legislation a crucial part of the White House's effort to end "the lawsuit culture in our country." The bill previously failed in 2003 and 2004 but passed swiftly through the Senate on a 72-26 vote. In brief, the Act has two principal parts. One set of provisions establishes new procedural and substantive standards applicable to class action settlements. The other set of provisions provides for both original federal jurisdiction and removal of state law-based class actions that until now could be filed only in state courts. For cases filed after February 18, 2005, the Act will move most large multi-state class action lawsuits from state to federal courts. The Act has not had a discernible impact yet, but most agree that it will add cases to the already overburdened federal court dockets. *Legal Times, Feb. 7, 2005; New York Times, February 20, 2005.*

"Good Old Boy" Defense Fails For WorldCom CEO Bernie Ebbers. A Manhattan federal jury convicted former WorldCom chief executive Bernie Ebbers, 63, of all criminal charges for masterminding an $11 billion fraud that sent the company into the largest bankruptcy in U.S. history. Ebbers, who worked as a milkman, bouncer and high school basketball coach before transforming a small Mississippi telephone company into the second largest long distance provider, testified in his own defense that he was unaware that his subordinates were cooking the books for 18 months. Ebbers claimed he had no head for numbers, a limited formal education and provided leadership but little actual direction to company executives. However, his former chief financial officer Scott Sullivan testified that Ebbers was a "hands on" manager who instructed him to hide expenses and overstate revenue beginning in 2000 so that the company could meet Wall Street expectations. Ebbers faces sentencing of up to 75 years and could spend the rest of his life behind bars. *Bloomberg News, Mar. 15, 2005.*

Deloitte & Touche Seeks "Catastrophe" Relief from Corporate Fraud Claims. Deloitte & Touche, the second-largest public auditing company, has appealed to lawmakers for relief from "catastrophic negligence claims." According to Deloitte's global chief executive: "The cost of litigation has been skyrocketing over the past couple of years . . . The lawmakers need to have a better understanding of our business and the significant risk inherent in the audit process." The firm's parent organization Deloitte Touche Tohmatsu refuses to accept any liability for audit failures at Deloitte's foreign offices. Deloitte's U.S. and Italian offices as well as its parent are defendants in a $10 billion lawsuit over a massive fraud at the Italian dairy giant Parmalat. Deloitte's Italian business certified the accuracy of Parmalat's accounts. Parmalat faces both criminal prosecution and civil lawsuits in what the SEC has called "one of the largest and most brazen corporate financial frauds in history." Deloitte seeks emergency relief from U.S. lawmakers because it fears that penalties and judgments relating to Parmalat and other cases may bankrupt the accounting company, leaving only three major public accounting firms. Federal emergency relief for accounting professionals would be unprecedented, although the U.K. government signaled in February that it plans to limit auditor liability and President Bush has made tort reform an agenda for his administration's second term. The Business Roundtable, a private organization made up of chief executives from some of the largest U.S. public companies, has also voiced its support for liability caps. Roundtable president John Castellani believes that limiting liability will actually encourage smaller auditing firms to compete against the Big Four. *AccountingWEB, January 18, 2005; Financial Times, March 1, 2005.*

Error-Driven Financial Restatements on the Rise. An independent financial consulting firm found that U.S. companies restated financial results in record numbers last year. Restatements due to error increased 28 percent in 2004 over the prior year. According to the report from Huron Consulting Group, Inc., the remarkable rise might be attributable to better oversight and more errors being caught, rather than more errors occurring. Sarbanes-Oxley and heightened scrutiny have caused public companies to "thoroughly document, test and take responsibility for the effectiveness of their company's safeguards for quality financial reporting," according to the report's author Joseph J. Floyd. In 2004, there were 414 restatements of quarterly or annual financial reports due to improper revenue booking or errors in accounting for stock options, accounts receivable, inventory, restructuring and other loss contingencies. Previously, the record number for restatements due to mistake was 330 in 2002. Tyco International Ltd. was the worst offender, having the most restatements annually since 1997. Approximately 15% of the companies restating in 2004 were repeat offenders. The report also noted a continued trend in companies restating more than one year of financials in a single filing. For the fifth consecutive year, the number of filers reporting errors in at least three prior annual periods rose — to nearly 40% of the annual reports restated. *The Wall Street Journal, January 20, 2005.*

Wall Street Analyst Pay Plummets After New Regulations Prohibit Covering Issues Underwritten by Same Firm. Once giants among Wall Street's elite, receiving lavish pay, bonuses and the adoration of the companies they followed, analysts today have fallen on hard times as firms slash compensation after U.S. regulators barred them from issuing biased research to help firms win investment banking business. According to research from a New York executive search firm that specializes in recruiting Wall Street analysts, the golden era is over and compensation has dropped about 50 percent since 1999. In 2003, research budgets at the seven biggest U.S. securities firms fell about 40 percent from 2002 to $1.5 billion as companies fired analysts and cut their compensation. *Bloomberg News, January 10, 2005.*

Nortel Executives Forced to Pay Back Bonuses. After restating its financial results for the years 2001-2003, Nortel completed a company-wide shakeup that included bringing on a new president and chief executive, reshuffling other executives and dismissing five directors. The company is now demanding that a dozen Nortel executives return to the company nearly $9 million in performance bonuses that were awarded based on faulty accounting during the restated period. Other companies are sure to follow suit. Under the Sarbanes-Oxley Act, the chief executive and financial officers of any company that restates due to misconduct must reimburse the company for bonuses and stock sale profits realized during the restated period. Presently, HealthSouth is pursuing payments received by its former chairman Richard Scrushy, who is on trial for criminal fraud. Fannie Mae executives also received nearly $6 million in bonuses based on bogus accounting, which may be subject to forfeiture under Sarbanes-Oxley. *Business Week, January 24, 2005.*

Marsh & McLennan Executives Plead Guilty to Criminal Fraud in Bid-Rigging Scandal. Four Marsh & McLennan executives have pleaded guilty to criminal charges in connection with an ongoing probe by New York Attorney General Eliot Spitzer into fraud and bid-rigging in the insurance industry. In January, senior vice president Robert Stearns admitted that during the period from 2002 to 2004, he instructed insurance companies to submit noncompetitive bids for business. Stearns would then pass these bids on to Marsh clients, who thought they were getting competitive quotes. By controlling the bids, the insurance broker was able to control which insurance company was awarded business and thereby maximize Marsh's fee. In February, three other Marsh executives pleaded guilty to fraud and admitted creating fictitious bids in an effort to charge customers higher premiums. Last year, Marsh's CEO resigned while several other executives were fired. The company settled Spitzer's civil fraud suit for $850 million, which was paid in restitution to customers who were cheated by the bid-rigging scheme. *CNNMoney, January 6, 2005; New York Times, February 15, 2005.*

Grand Jury Indicts Peregrine Executives in $4 billion Fraud Scheme. A federal grand jury in San Diego, California handed up an indictment charging eight former executives at Peregrine Systems, Inc., one former outside auditor, and two Peregrine business partners with conspiracy to commit a $4 billion securities fraud. Peregrine has been the subject of investigations by the SEC and the FBI in conjunction with the U.S. Attorney General, U.S. District Attorney for the Southern District of California since early 2002 when the company announced possible misstatements in prior financial reports. Later that year, Peregrine filed for federal bankruptcy protection, eventually canceling its common stock leading to the loss of over $4 billion in shareholder equity. Between its initial public offering in 1997 through 2002, Peregrine reported 17 consecutive quarters of revenue growth that met or exceeded Wall Street analysts' expectations. Peregrine's stock rose from its IPO price of $2.25 per share to almost $80 per share. Thus far, at least four former Peregrine executives have pleaded guilty to criminal conspiracy and are cooperating in the ongoing government investigation. *San Diego Union Tribune, February 27, 2005.*

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(HARD) TIMES

Continued from page 3.

Former HealthSouth CEO Richard Scrushy testifying before Congress.

The trial of HealthSouth's former CEO, Richard Scrushy, began in January. Scrushy's attorneys have blamed the $2.7 billion accounting fraud at the company on more than 10 trusted lieutenants, contending they took extraordinary steps to hide the scheme from him. Scrushy faces more than 40 criminal charges and the possibility of life in prison.

judges by telling them to consider the guidelines simply as suggestions rather than firm parameters. Previously, judges were bound to determine punishment using a 1,800-page sentencing manual written by the congressionally established Sentencing Commission. Many federal judges are expected to continue to use the federal sentencing guidelines, even though they are no longer required to do so. In addition, Congress may intervene by passing tough mandatory minimum sentence laws in a way that does not violate the Constitution. Still, lifting the threat of long sentences mandated by the sentencing guidelines deprives the Justice Department of a certain amount of leverage when trying to persuade defendants to plead guilty and cooperate.

Cooperate or Else

The apex of criminal sentencing for corporate malfeasance came when Jamie Olis, a former tax director at the Houston energy company Dynegy, was sentenced to 24 years in prison for illegally disguising the company's debt. He had been convicted of conspiracy and fraud in late 2003 for helping disguise a $300 million loan to Dynegy as cash flow from a gas trade. Because there is no parole in the federal system, Olis will not be released until he is 62 years old.

Olis received such a long sentence because he refused to cooperate with prosecutors by naming other offenders at Dynegy and because he declined to accept a plea bargain, placing his faith instead in the judicial process. Even after Olis received the 24-year sentence, he still refused to testify against others at the electricity and natural gas company in exchange for the possibility of reduced jail time. Two of Olis's co-workers reached plea agreements that include no more than five years in prison. At Olis's trial, witnesses named about a dozen higher-ranking Dynegy executives and outside lawyers as co-conspirators. None of them has been charged with wrongdoing, and without Olis's testimony, they may never be.

The message behind Olis's sentence is clear: cooperate with prosecutors and enter into a plea bargain or face a very long period of incarceration.

"Olis's problem was that he chose to go to trial," said Wayne State's Henning. "If you cooperate enough, the government can file a motion to release the judge from the sentencing guidelines. This lets the judge sentence the defendant to any amount of time he feels is appropriate. The pressure is enormous to cooperate."

Henning noted that Michael Martin, chief financial officer at HealthSouth between 1997 and 2000, received only six months of home confinement and 60 months of probation in exchange for his guilty plea and agreement to cooperate in the investigation of the company. (Martin also agreed to forfeit $2.4 million to the government.) When Martin pled guilty in April 2003, he became the ninth person charged in the case. All nine of those defendants agreed to cooperate with the government's investigation in the hope of avoiding a crushing blow from the tough new federal sentencing guidelines. By November 2003, the number of HealthSouth executives who had agreed to plead guilty to participating in the nearly $3 billion accounting fraud had risen to 15.

Rise of the Corporate Fraud Task Force

While judges are handing out tougher sentences to corporate criminals, the Executive branch of government has become more active in catching and prosecuting them. President Bush created a Corporate Fraud Task Force in July 2002, combining senior officials from the Justice Department, the SEC and several other federal agencies. Between the inception of the Task Force and May 31, 2004, Justice Department prosecutors:

(1) Obtained over 500 corporate fraud convictions or guilty pleas;

(2) Charged over 900 defendants and more than 60 corporate CEOs and presidents with some type of corporate fraud crime in connection with over 400 charged cases;

(3) Secured charges against 31 Enron defendants, including 21 former Enron executives;

(4) Seized more than $161 million for the benefit of victims of the fraud at Enron.

"Numerous high-profile acts of deception in corporate America have shaken the public's trust in corporations, the financial markets, and the economy," said Task Force Chairman James B. Comey. "A few dishonest individuals hurt the reputations of many honest companies and executives. They hurt workers who committed their lives to building the companies that hired them."

Several High-Profile Trials and Sentencings Remain

WorldCom's Ebbers is merely one of several high-profile corporate executives who have been placed on trial or who will go to trial soon. The trial of HealthSouth's former CEO, Richard Scrushy, began in January. Scrushy's attorneys have blamed the $2.7 billion accounting fraud at the company on more than 10 trusted lieutenants, contending they took extraordinary steps to hide the scheme from him. Scrushy faces more than 58 criminal counts and the possibility of life in prison.

While judges are handing out tougher sentences to corporate criminals, the Executive branch of government has become more active in catching and prosecuting them.

Former Enron CEO Ken Lay under arrest.

Kenneth Lay, who served as Enron's chief executive for 15 years, was finally indicted in July 2004, more than two years after the company's bankruptcy. Lay's trial is expected to begin later this year.

Scrushy's lawyers have tried desperately to discredit the testimony of his former lieutenants. As an example, they asserted that former Chief Financial Officer Michael Martin is on a "mood-altering drug," suggesting his recollections of accounting fraud at the company shouldn't be trusted. That drug is the common antidepressant Lexapro, which is in the same widely used family as Prozac and Zoloft. Former finance chief William Owens was easier to discredit, since he failed to file personal tax returns for nearly a decade.

Kenneth Lay, who served as Enron's chief executive for 15 years, was finally indicted in July 2004, more than two years after the company's bankruptcy. Lay was charged with conspiracy to commit securities fraud, four counts of securities fraud, two counts of wire fraud, one count of bank fraud and three counts of making false statements to a bank. A grand jury had previously indicted former Enron President Jeffrey Skilling and former Enron Chief Accounting Officer Richard Causey. Last October, U.S. District Judge Sim Lake separated the bank fraud charges from the broader conspiracy case against Lay and his two co-defendants, Skilling and Causey. The conspiracy trial of the three men is scheduled to take place in January, 2006. All three have pleaded not guilty to all charges. The Justice Department's Enron Task Force wanted to try Lay on the bank fraud charges in May or June, but the judge has pushed the trial on those charges into 2006 also.

In April, a federal judge in Houston gave two former Merrill Lynch & Co. officials substantially shorter prison sentences

Continued on page 10.

(HARD) TIMES

Continued from page 9.

than the government was seeking in a high-profile case that grew out of the Enron scandal. Judge Ewing Werlein sentenced former Merrill investment banking chief Daniel Bayly to 30 months in federal prison and James Brown, who headed the firm's structured-finance group, to a 46-month term. By contrast, the Justice Department was seeking sentences for Bayly and Brown of about 15 and 33 years, respectively. Judge Werlein opted for much lighter sentences because the role that the two Merrill Lynch bankers played in Enron's collapse was very small. Enron's sale to Merrill of some electricity-producing barges off the Nigerian coast allowed Enron to illegally book $12 million in pretax profit, a small sum in comparison to the overall fraud at the Houston energy company.

The re-trial of Tyco International Ltd.'s two former top executives started in January. Former CEO Dennis Kozlowski and former Chief Financial Officer Mark Swartz are accused of "systematically looting" the Bermuda conglomerate in part to support their lavish tastes. Prosecutors have alleged that Swartz and Kozlowski improperly granted more than $37 million in loan forgiveness to themselves as a bonus without the approval of Tyco's directors or compensation committee. They each face up to

Former Tyco CEO Dennis Kozlowski.

Former Tyco CEO Dennis Kozlowski and former Chief Financial Officer Mark Swartz are accused of "systematically looting" the Bermuda conglomerate in part to support their lavish tastes.

25 years in prison on the most serious charge of grand larceny. Both have denied wrongdoing.

Joseph Nacchio, the former CEO of Qwest Communications, hasn't been indicted. However, on March 15, 2005, the SEC charged Nacchio and eight other former Qwest officers and employees with fraud and other violations of the federal securities laws. In three separate but related civil actions, the SEC alleged that Qwest fraudulently recognized over $3 billion of revenue and excluded $71.3 million in expenses. In October 2004, Qwest itself agreed to pay a $250 million penalty to the SEC for its misconduct.

The SEC's complaints against Nacchio and another eight former executives seek injunctions, disgorgement of ill-gotten gains, and civil penalties. The SEC is pursuing officer/director bars against Nacchio and five other defendants.

"The disclosure fraud at Qwest was orchestrated at the highest level of the company to deceive investors," said Randall J. Fons, Regional Director of the SEC's Central Regional Office in Denver.

While the government has taken civil action against Qwest, its attempts to obtain criminal convictions largely have failed. In February, a federal judge sentenced former Qwest executive Thomas Hall to probation and a $5,000 fine and said no one charged in the government's investigation of fraud at the telecom-

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munications concern will go to prison. Hall, who pled guilty last year to a single misdemeanor count of falsifying documents, was the first person sentenced in the case. Two years ago, a grand jury indicted four executives on 12 felony counts each.

Adelphia Communications Corporation founder John Rigas and his son, Timothy, were found guilty of conspiracy and fraud in July 2004. The jury sided with prosecutors' allegations that the two men looted more than $100 million from the cable company, hid more than $2 billion in debt the family incurred, and lied to the public about Adelphia's financial condition. They await sentencing. Michael Mulcahey, the only non-Rigas family executive at Adelphia indicted on charges of conspiracy and fraud, was acquitted on all 23 counts against him. After a deadlocked jury trial, one of Mr. Rigas' other sons, Michael, will be tried again later this year.

While stepped-up criminal enforcement against executives who commit accounting fraud is a step in the right direction, there remains a need for private-sector civil suits. In criminal proceedings, executives often are forced to disgorge only ill-gotten gains that flowed to them directly, such as insider trading profits. There may be little or no restitution for public investors. Securities class action suits force corporations to repay investors for sins committed by a previous management team. In addition, the standard of proof required in criminal cases remains high. In our judicial system, we believe it is better to let a guilty man go free than to convict an innocent one. Thus, civil suits may be able to recover damages for investors even in cases where criminal prosecution is absent or has failed.

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"Get you off? You'll be lucky if I can defend you with a straight face!"

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BEYOND CRIMINAL PROSECUTIONS

Continued from page 5.

shareholders, the largest amount paid by an accounting firm in an SEC action. The individual auditors at KPMG — all certified public accountants — agreed to suspensions from practicing before the SEC. Finally, the SEC is tightening its policy on forcing individuals to pay their fines out of their own pockets, recently requiring directors that are settling SEC enforcement proceedings to represent in writing that they are not being indemnified for any fines they have agreed to pay in connection with the settlement.

There is little doubt the historic settlements in *WorldCom* and *Enron*, and the increased activism of the SEC, have created a new paradigm in corporate boardrooms across America. Rather than sitting back and relying upon the security of D&O insurance, directors and other "gatekeepers" now face the reality of writing a personal check to cover losses caused by their failure to adequately perform the duties they were entrusted with. Through the activism of institutional shareholders, directors and other "gatekeepers" can now expect to pay for failing to be diligent and independent in fulfilling their fiduciary obligations to shareholders.

Just witness the record $6 billion paid by WorldCom's underwriters in settlements in that action led by the New York State Common Retirement Fund. These settlements amounted to over 60 times the fees the underwriters received from WorldCom for their work. The settlements (and the heightened duty of underwriters as established in the decisions of the Court in that case) will be the subject of a lengthy article in the next issue of the *Advocate* — STAY TUNED!

Timothy Delange, the current Editor of the Institutional Investor Advocate, *is an associate in the California office of BLB&G. He prosecutes securities actions on behalf of the firm's institutional investor clients. He can be reached at timothyd@blbglaw.com.*

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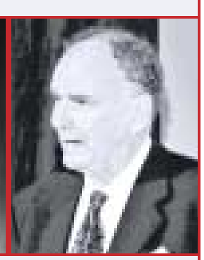

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