

# Advocate

A SECURITIES FRAUD AND CORPORATE  
GOVERNANCE QUARTERLY

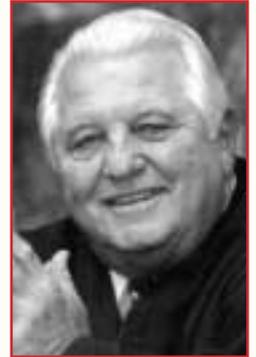
## CONGRESS, THE SEC AND PRIVATE LITIGATION: MENDING CORPORATE AMERICA

**By Harvey Goldschmid**  
*Dwight Professor of Law, Columbia  
University School of Law and former  
Commissioner, Securities and Exchange  
Commission, 2002-2005*

The date was July 31, 2002. The President had just signed the Sarbanes-Oxley Act into law the previous day. Financial markets were in turmoil. The corporate world was in disrepute. This is the date I was sworn in as a Commissioner of the Securities and Exchange Commission. Now things are still imperfect, but because of Sarbanes-Oxley, the SEC, and private litigation, things have significantly improved. A large element of public distrust has disappeared. I have been asked to provide you with a progress report on what the SEC did during the three years I served as Commissioner, and to address what I believe is the largest failure at the SEC, the failure to provide proxy access to shareholders.

Let me begin by stating my bottom line for the scandals of the late 1990s and early 2000s: there was systemic failure. The checks and balances expected from independent directors, independent accountants, securities analysts, commercial and investment bankers, lawyers and compliance personnel too often failed. During the past three years, serious SEC rule-making and enforcement efforts have taken place in each of these areas.

Independent directors are the most significant actors in the U.S. corporate governance system. But the most important insight to be gained from the recent scandals is that even active, demanding, independent directors cannot carry the load alone. The U.S. corporate governance system is heavily dependent on the effectiveness of various gatekeepers.

*Continued on page 2.**Harvey Goldschmid**Nicholas Politan*

*In this issue of the Advocate, we are pleased to publish excerpts from Professor Goldschmid's and Judge Politan's speeches at the October 20, 2005 Institutional Investor Forum in New York City.*

## MEDIATING SECURITIES CLASS ACTIONS: A VIEW FROM THE CAPTAIN'S QUARTERS

**By The Honorable Nicholas Politan,**  
*U.S.D.C., District of New Jersey (Ret.)*

Today, the majority of, if not all, securities class actions wind up in mediation. Indeed, when the plaintiff and defendant analyze the risks of continuing litigation, there is a logic that forms which brings the parties' respective positions to certain points. The parties then come to mediation and the question arises, "how do we settle this case?" This is a big gray area, and that's where the mediator works. The mediator attempts to captain both parties to what the mediator thinks is their logical, reasonable position, and then works within that framework to develop a mutually agreeable compromise. This article provides insight into the process from the mediator's perspective—or from the "captain's quarters"—because in the end, it is the mediator's responsibility to navigate the parties towards settlement.

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## MENDING CORPORATE AMERICA

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### Strengthening of the Accounting Profession

Accountants are perhaps our most important gatekeepers. Two key issues were before Congress in creating Sarbanes-Oxley: one, how to strengthen

the relationship between independent accountants and independent directors; and two, how to strengthen the accounting profession itself. The overriding concern on everyone's mind was that honest corporate numbers are fundamental to making the system work.

Perhaps the most important thing that the Commission did in the corporate

governance area, and that Congress did in Sarbanes-Oxley, was to require the audit committee to take "direct responsibility" for the hiring, the evaluation, the compensation, and, where appropriate, the firing of the outside auditor. The words "direct responsibility" sent a powerful message, both from Congress and the SEC.

In addition, Sarbanes-Oxley added provisions for anonymous and confidential reporting and the hiring of outside experts to assist the audit committee. In conversations with both audit partners of major firms and audit committee members at major public corporations, it is clear that the "direct responsibility" mandate and the other audit committee reforms have had a dramatic effect. Now, there is more questioning, more interaction and an improved relationship between the independent directors and the outside auditor – this is an improvement in corporate governance of large consequence.

At the heart of Sarbanes-Oxley was the establishment of the Public Company Accounting Oversight Board. The PCAOB was established in large part due to a basic failure of self-regulation by the accounting profession. There was almost no internal discipline from the accounting profession itself. The rule-making process was suspect; the inspection process was questionable. The system was not working.

The PCAOB now has serious inspection, rule-making and disciplinary powers. It has grown from members of the Board answering their own telephones three years ago, to a staff of nearly 400 and a budget of roughly \$137 million. The PCAOB has been a great success in terms of how well it has gotten off the ground.

Sarbanes-Oxley and the SEC have also eliminated the perverse conflict of interest created by excessive consulting fees paid to the auditing firm. Sitting as general counsel of the SEC in our confidential enforcement proceedings—and again, as a Commissioner for three years—

## Inside Look

This quarter, the *Advocate* is pleased to bring you articles summarizing two of the keynote addresses from our 11th Institutional Investor Forum on October 20 and 21, 2005.

On October 20, 2005, Harvey J. Goldschmid, the Dwight Professor of Law at Columbia University School of Law and former SEC Commissioner, delivered his well-received keynote address on the role and future direction of the SEC. In "Congress, the SEC and Private Litigation: Mending Corporate America," Professor Goldschmid provides a progress report on what the SEC did during the three years he served as Commissioner and addresses his view on the largest failure at the SEC – the failure to provide proxy access to shareholders. As Professor Goldschmid details, independent directors are the most significant actors in the U.S. corporate governance system and many of the recent SEC rules have focused on reporting as much information as possible up the chain of command to the independent directors. Finally, the article analyzes the lack of an appropriate mechanism to get shareholders further involved in corporate governance and offers suggestions to strengthen shareholder power in the United States today.

In "Mediating Securities Class Actions: A View From The Captain's Quarters," the Honorable Nicholas Politan, a retired United States District Court Judge and widely respected securities mediator, provides a snapshot of the mediation process from his

unique perspective in the captain's chair navigating the parties towards settlement. Judge Politan focuses on the current landscape of securities mediation, including the benefits of the active involvement of institutional investors, the mosaic rules of insurance, and the roles of the securities lawyers and the mediator. As Judge Politan concludes, an effectively administered mediation requires experience and expertise from the parties, the lawyers and the mediator.

Apart from the two main articles, I refer you to the 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 again provides an insightful compilation of the most significant developments in the field for your quick reference.

As previously referenced, we hosted our 11th Institutional Investor Forum on October 20 and 21, 2005 in New York City. We would like to again thank everyone who attended the Forum. We are told that the attendees found the Forum to be informative and enjoyable. If you would like to attend our next Forum on October 5 and 6, 2006, please contact us.

We hope that you will enjoy this issue of the *Advocate*. As always, we welcome your comments, questions and input. On behalf of everyone at Bernstein Litowitz Berger & Grossmann LLP, we wish you and your families all of the joys of the holiday season and a happy and healthy New Year.



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I witnessed time and again situations where the amount of dollars involved in consulting appeared to have had a serious negative effect on the auditor’s independence, on his or her willingness to bend and move in the wrong direction under financial pressure. When the consulting fees are two or three times the amount of auditing fees, the pressures that creates are understandable. Sarbanes-Oxley and the SEC have greatly diminished the adverse potential of this conflict of interest. There is still room for consulting, but it is in narrowed areas and must be approved by the independent members of the audit committee; a realistic limit has been placed on the overall weight of consulting dollars.

## Requiring Corporate Lawyers to do the Right Thing

Section 307 of Sarbanes-Oxley requires corporate lawyers to report potential wrongdoing and fiduciary breaches up the chain of command, and ultimately to the independent directors, if necessary. For present purposes, Section 307 has three basic concepts. One, reporting up would provide corporate lawyers, both inside and outside, the ability to ethically and legally report concerns and potential malfeasance up the chain of command. Two, it’s going to prevent decisions that create material harm to corporations

from being made at middle level corporate management. Finally—and there’s legitimate debate about this, but I have no doubt about its wisdom—it moved the role of the corporate lawyer in the public corporation into a federal realm. Until now, reporting up or reporting out—which is a separate issue, an important one—was handled by state law and state disciplinary bodies. The general disciplinary groups in the various state bars simply did not focus on issues of securities law. Rather, they focused on lawyers’ hands in the trust fund or other problems of that type.

We now have the SEC able to enforce this reporting-up, armed with the entire arsenal of SEC sanctions, from civil penalties to injunctive relief to prohibitions against appearing before the Commission. Again, this will make a system that was perfectly ineffective under state disciplinary rules far more effective.

## Putting the Spotlight on Corporate Management

Sarbanes Oxley also increased the disclosure requirements, mandating a certification by CEOs and CFOs of corporate financial information. The reality,

however, is that these certifications add almost nothing in terms of exposure to the law. The “almost” is because there are some criminal provisions that kick in at heavier penalties. But in the civil context, even prior to Sarbanes-Oxley, when the CFO and CEO signed a quarterly report, or a financial, they were legally taking responsibility for that document.

The certifications did, however, put a spotlight on the importance of the CEO’s and CFO’s signature and that had a dramatic effect. Now, CEOs and CFOs want to know where the numbers are coming from and about the quality of the information supporting those numbers. I have no doubt that disclosure today is considerably better, not because of increased legal exposure, but because people finally understand the importance of signing their names to the company’s financial statements.

There has been a scream that grows louder in the business community relating to the cost of Sarbanes-Oxley. It ought to be made clear that Sarbanes-Oxley is not an expensive bill. The only significant cost item is the internal controls provisions of Section 404. The rest of the “great cost claims” are nonsense. Internal controls are always going to be

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a large ticket item, but they are a basic need of modern public corporations.

No one can seriously argue that internal controls are unnecessary. But the costs have been a problem. And there is little doubt that some wheels have been spinning that need not have been. Under the system, year two ought to be less expensive than year one, and year five should be considerably less expensive. But there are questions about how it has been implemented. Additionally, the SEC ought to look at whether the framework

*In an area where most Americans put their capital investment, the late trading and market timing activities that occurred in the mutual fund industry cannot be described in words less than “national disgrace.”*

that applies to large public corporations like GE should be applied to smaller public corporations. But internal controls are an enormous public benefit, and the trick now is to hold down unnecessary costs.

### The Mutual Fund Industry

In an area where most Americans put their capital investment, the late trading and market timing activities that occurred in the mutual fund industry cannot be described in words less than “national disgrace.” The willingness to take side payments and sticky assets was a venal breach of the public trust.

The SEC responded by taking steps, and continues to take steps, to eliminate the use of market timing, late trading, directed brokerage, and other abusive practices. The SEC also focused on mutual fund governance, requiring an independent chair of the board, 75 percent independent directors, and a Chief Compliance Officer who is required, as are the lawyers and accountants, to report problems and potential scandals upward to the independent directors. Again, the SEC focused on reporting up, creating a mechanism to provide as much information as possible to the independent directors.

### SEC Enforcement on the Rise

Good rules may be of little value unless they are enforced. There are two kinds of basic enforcement in the United States, one by the Commission itself, and the other by private law firms acting for investors. Both are absolutely critical. As the SEC has stated for 70 years, private enforcement is vital to making the system work.

Sarbanes-Oxley provided the government with substantial new powers in terms of civil money penalties and other remedies. Congress recognized that mutual funds, corporations, directors, officers, and the various gatekeepers must be held accountable for wrongdoing. Effective deterrence requires a strong and credible threat. It is that threat that creates powerful incentives to avoid wrongful acts, and to bring about the cultural and procedural changes that will keep the corporation on the right track.

Quantitatively, SEC enforcement has increased dramatically. Today, the cases are larger and more complex than ever. In fiscal 2002, the SEC took its first \$10 million civil penalty from a public corporation. There were 20 such penalties in 2003, and 40 in 2004. In both 2003 and 2004, the SEC collected more in civil penalties than had been collected in the prior 15 years combined. It was not just the civil penalties. To be an effective

*Effective deterrence requires a strong and credible threat.*

*It is that threat that creates powerful incentives to avoid wrongful acts, and to bring about the cultural and procedural changes that will keep the corporation on the right track.*

deterrent, the entity or individual must pay that penalty and feel the pain. Now, unlike before, payment of an SEC civil penalty may not be reimbursed, insured, or used for tax deductions.

I hasten to add, this system will not work unless qualified individuals continue to serve as officers and directors of public corporations. We must not unfairly frighten them away from serving. The SEC does not want to diminish or interfere with risk taking, corporate entrepreneurial activity, or with appropriate corporate autonomy. Corporate risk can create new product, innovation, efficiency, and healthy change. The SEC simply asks: if the business decision goes right, disclose it; and if it goes badly, disclose that too.

### Shareholder Rights and Proxy Access

Shareholders, who put up the investment capital, have precisely the right instincts in our economic system. Shareholders who understand the game are concerned about efficiency, productivity, honesty, and, of course, share price and profitability. Strengthening shareholder power is the most dramatic and effective way to improve corporate governance in the United States today.

In an ideal system, the shareholders are well represented by the board of directors. But what happens when the board does not adequately represent their

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interests? When the company is struggling and nothing is happening to bring about change? What can shareholders do? Unfortunately, under our current system, the answer is not enough. Shareholders can certainly sell out, the so-called "Wall Street walk." But from a corporate governance standpoint, that is not enough. Something needs to be done to remedy the problems, to create mid-course corrections, to prevent the company from falling into bankruptcy.

The "Wall Street walk" has some effect, but not enough in the governance context. This is where proxy fights could dramatically improve the system. Under the current system, management and incumbents can spend freely on proxy fights. Phone banks, advertisements, letters, and everything else in a modern campaign are automatically reimbursed by the corporation. Insurgents, on the other hand, are reimbursed only if they win. Thus, it is too costly and risky to run a proxy fight, and the numbers bear that out. Cured for special situations and small cap companies, there are only one or two proxy fights a year in the United States among all of our public corporations. That is economically irrational.

Now the SEC put out proposals in October of 2003, which were fiercely opposed by the Business Roundtable and the CEO community, who argued that the proposals were too complex and could put "radicals" on the board. What they didn't note was that the pro-



posals were complex because they were meant to protect against inappropriate pressures or wild-eyed types getting on a board. The proposals were aimed at stimulating "dead" companies that desperately need help.

Hopefully, proxy access is not dead. The SEC proposals can be streamlined. Other proposals can be explored. The bottom line is that the proxy process needs to be improved one way or the other. There has to be a mechanism to get shareholders further into this game. Right now, the election process is unfairly and unwisely a closed system. Ultimately, proxy access could have at least as much effect in the governance area as the lead plaintiff provisions have had in cleaning up a lot of the problems in the litigation area.

## The Long View

Let me close on an optimistic note. Over the last three years, serious SEC rule-making and enforcement efforts have occurred. Officers and directors, accountants, lawyers, mutual funds, hedge funds and others in the financial community have been dealt with sensibly and with balance. The scandals of the 1990s and early 2000s made us face serious systemic imperfections. They also made it possible to bring about reform. I believe that Sarbanes-Oxley, along with the efforts of the SEC and private litigation, will permit the United States to maintain and strengthen its position as a world leader in corporate accountability and financial disclosure.

*Harvey Goldschmid is the Dwight Professor of Law at the Columbia University School of Law, where he has taught since 1970. From 2002 to 2005 he served as a Commissioner at the United States Securities and Exchange Commission. In 1998-99, he served as General Counsel (chief legal officer) of the SEC, and from January 1 to July 15, 2000, he was Special Senior Advisor to SEC Chairman Arthur Levitt. Commissioner Goldschmid is the author of numerous publications on corporate, securities, and antitrust law and a frequent lecturer at national and international legal programs and seminars. He received the 1999 Chairman's Award for Excellence from the SEC, as well as several teaching awards. Commissioner Goldschmid served in 1997-98 as a consultant to both the Federal Trade Commission and the SEC, and during this period, was a member of the Legal Advisory Committee (and Chair of its Subcommittee on Corporate Governance) of the New York Stock Exchange.*



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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## Eye On The Issues

LEGISLATIVE/REGULATORY UPDATES  
AND RECENT DECISIONS OF INTEREST

By Benjamin Galdston

**Big Four Accounting Firm Audits Criticized By Accounting Oversight Board.** In a November 2005 report, the Public Company Accounting Oversight Board ("PCAOB") faulted the "Big Four" public accounting firms—PricewaterhouseCoopers LLP, KPMG LLP, Deloitte & Touche LLP, and Ernst & Young LLP—for deficiencies in audits performed by the firms during 2004. According to separate reports on the firms, the deficiencies were serious enough in audits prepared by 3 of the 4 firms for the Board to conclude that in several instances the accounting firms failed to obtain "sufficient competent evidential matter" to support their opinions on certain clients' financial statements. The PCAOB was established by the Sarbanes-Oxley Act of 2002 and is responsible for inspecting registered accounting firms to ensure compliance with the provisions of the Act, the rules of the PCAOB, the rules of the Securities and Exchange Commission, and the Generally Accepted Accounting Principles and other applicable professional standards. The Board performed limited inspections on the four largest U.S. public accounting firms in 2003. In 2004, the Board performed expanded reviews of audits performed by the "Big Four," as well as audits by nearly 170 other registered public accounting firms. In each case, the Board reviewed selected unidentified audit engagements for deviations from applicable professional standards, with a particular focus on "high risk" areas such as revenue recognition, reserves, and related-party transactions. The Board found that PricewaterhouseCoopers LLP and Ernst & Young LLP committed the most numerous and serious departures from professional standards, but found fault in audits prepared by all four firms. [www.pcaobus.org/Inspections/Public\\_Reports/](http://www.pcaobus.org/Inspections/Public_Reports/)

**Two Months After Going Public, Refco Files For Bankruptcy Amid Massive Accounting Fraud.** In October, Refco Inc., one of the world's largest commodities and futures brokers, was forced to file for bankruptcy protection just two months after its initial public offering in August after disclosing dubious related-party transactions between the company and its chairman, president and CEO, Phillip Bennet. Signs of trouble at the Chicago trading firm became public on October 10 when Refco announced that Bennet, 57, had been put on an indefinite leave of absence after the company discovered that an investment fund Mr. Bennet controlled owed Refco \$430 million. Upon hearing the news, Refco customers began withdrawing their assets from the securities firm in droves. Seven days later the company filed for bankruptcy. Following his suspension, Bennet repaid the \$430 million but Refco announced that it might have to restate its earnings going back to 2002. On

October 12, Bennet was arrested and charged by federal prosecutors with fraud. According to the indictment, Bennet hid certain related-party transactions from investors that were used to cover up the \$430 million debt. At its peak, Refco had just \$150 million in equity supporting some \$50 billion of assets—meaning the debt Bennet hid effectively left the company with a negative net worth. Bennet has since pleaded not guilty and the company sold off its core futures brokerage business to an investor group for \$768 million. *The New York Times*, Nov. 18, 2005.

**Hollinger International Executives Indicted For Fraud.** In November, media tycoon Conrad Black and three other executives from the Hollinger International, Inc. media empire were indicted for mail and wire fraud, charged with looting millions of dollars from the company, cheating on taxes, and falsifying company records. Hollinger owns the Chicago Sun-Times and other publications in the United States and Canada. In a scheme federal prosecutors have called "the grossest abuse by directors and insiders" and a "corporate kleptocracy," Black allegedly dipped into corporate coffers at will, diverting more than \$83 million to support his lavish lifestyle. Black, 61, formerly a Canadian citizen, now serves as a member of the British House of Lords. The indictment alleges that Black used fictitious non-compete agreements to divert \$51.8 million from Hollinger International's multi-billion-dollar sale of assets in 2000 to CanWestGlobal Communications Corp. Other Hollinger executives, including John A. "Jack" Boulton, 62, a Toronto-based accountant, and Mark S. Kipnis, 58, Hollinger International's former top in-house counsel, siphoned off \$32 million in proceeds from the sale of newspaper properties in the U.S. and Canada through bogus contracts with purchasers. Black used the stolen cash to purchase lavish apartments in New York and fund vacations in French Polynesia, using a corporate jet to fly himself and his wife around the world. The scheme began to unravel in August when Black's former right-hand-man David Radler, 63, was charged for his part in the scheme to divert \$32 million from Hollinger International. Radler pleaded guilty in September to one count of mail fraud and agreed to cooperate with prosecutors in their case against Black and the others. *The Wall Street Journal*, Nov. 18, 2005.

**Study Finds Economic Crime More Prevalent In 2005.** According to a recent survey of its global clients by accounting firm PricewaterhouseCoopers LLP, fraud continues to be the most important issue in the eyes of senior executives, as well as regulators. Surprisingly, although most respondents believe that fraud has declined significantly since 2003, the empirical results show that facts run contrary to perception. Internationally, Africa and Central and Eastern Europe reported the largest percentage increases in incidents of fraud between 2003 and 2005. In the United States, the number of companies reporting incidents of fraud has increased in every category since 2003. For example, there was a 71% increase in the number of companies reporting corruption and bribery between 2003

and 2005. During the same period, the number of companies reporting financial misrepresentation increased a whopping 140%. The statistics are puzzling because more companies have instituted stringent risk management systems and new legislation such as the Sarbanes-Oxley Act of 2002 has heightened penalties for violations. However, according to the study, despite the greater scrutiny and more severe repercussions, most fraud is still discovered by chance — not oversight. When fraud is discovered, companies respond in different ways. Most companies (80%) launched internal investigations and informed their Boards of Directors about the conduct. Less than two-thirds of respondents notified law enforcement agencies. In 89% of the financial misrepresentation cases, companies chose to conduct an internal investigation, but in only 84% of those cases did they inform their Boards of Directors and only 50% informed their Audit Committees. *Global Economic Crime Survey 2005, PricewaterhouseCoopers.*

***Prosecutors Seek To Void Legal Fee Agreements Covering Corporate Executive Defense In Fraud Case.*** In corporate by-laws or through executive employment agreements, most corporations agree to pay for the defense and indemnification of corporate officers who are sued in connection with their office. As a result, companies also typically advance the legal fees incurred by executives where they are charged with criminal fraud. But, in a high-profile white-collar crime case in Kansas, prosecutors successfully attacked the agreements and won a broad restraining order on the defendants' assets, including their right to advancement of their legal fees by the company. David Wittig and Douglas Lake, the former chief executive officer and corporate strategy vice president of Topeka-based Westar Energy, Inc., were on trial in Kansas federal court for fraud and conspiracy arising from \$37 million in missing Westar funds that the two were accused of stealing. Federal prosecutors argued that the defendants' right to legal fees was connected to their alleged misconduct, and thus were forfeited. After first granting the injunction, the district court placed the legal fees in escrow with instructions that the jury should decide the issue. In December 2004, the jury remained deadlocked without a criminal verdict and a mistrial was declared. Late this year the two were tried again and a new jury convicted Wittig and Lake of multiple charges. However, the jury found that the indemnification and legal fee agreements were not tied to the misconduct and, therefore, the company should pay for their legal defense. The effort by prosecutors and the broad injunction were unprecedented and viewed by many as a trend to come. *The National Law Journal, Oct. 11, 2005.*

***Disney Leads The Charge In Expensing Stock Options.*** On July 24, 2004, the U.S. House of Representatives passed the Stock Option Accounting Reform Act. The new law requires most public-reporting companies to expense stock options granted to its five highest paid officers and deduct the cost of options from company earnings beginning in fiscal year 2006, which

for most companies means the quarter beginning in January. The legislation marks an important change. For years, many companies used lavish stock option grants to reward key employees. Options were viewed as an easy compensation bonus, as well as a performance incentive. For the company, stock options cost very little. Stock was issued from the treasury and, unlike a cash salary, the options were not treated as an expense and had no effect on the company's bottom line. As a result, critics believe that the old accounting rules allowed companies to distort their income statements and make company-to-company comparisons difficult. Many companies resisted the new law, claiming option expensing would cut earnings per share, with tech and other option-heavy sectors possibly seeing much bigger income reductions because their stocks are typically more volatile. The Walt Disney Co. is leading the charge for expensing options. Disney, which was criticized by shareholders for option-heavy compensation and severance agreements with its executives, began expensing employee stock options in its fourth quarter of 2005, ending September 30, 2005. Disney said the accounting change will cost the company \$0.08 per share after taxes in fiscal 2005. *CNNMoney, Nov. 3, 2005.*

***SEC Scrutinizes Option Grants.*** The SEC is taking a closer look at the timing of option grants after completing a year-long investigation into a dozen companies. One of the companies investigated by the SEC — Analog Devices Inc. — agreed to pay \$3 million to avoid potential charges related to the handling of its stock-option awards. The investigations were prompted by ongoing academic research which found many companies seemed to have an uncanny knack for timing options grants. Studies found that the share price of hundreds of companies seemed to dip just prior to option grants and that, following the grants, the stock price improved after the companies announced good news to the market. The trend seemed to suggest that companies were back-dating options to maximize gains for the recipient. In November 2005, software maker Mercury Interactive Corp. admitted to such a practice. Mercury's chief executive and two other senior Mercury executives resigned after an internal investigation found they "benefited personally" from widespread manipulation of stock-option grant dates. Although back-dating is not illegal, the practice may raise disclosure issues. For example, companies may report in proxy statements that the strike prices for options are set at the market value on the date of a grant — generally when directors vote on the award — but then change the date after the fact to capitalize on a lower market price. That could constitute a misleading disclosure in violation of the federal securities laws. Additionally, back-dating options might violate accounting rules by underreporting the expense of the additional compensation given to executives in the form of discounted options. *Wall Street Journal, Nov. 11, 2005; CFO Magazine, Jan. 1, 2006.*

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## Gatekeeper Liability Update

### BIG FOUR PUBLIC ACCOUNTING FIRMS ATTEMPT TO LIMIT LIABILITY THROUGH MANDATORY ARBITRATION CLAUSES IN CLIENT SERVICES AGREEMENTS

For more than a decade, the biggest U.S. accounting firms, including Ernst & Young LLP and KPMG LLP, have been asking Congress to pass legislation that would limit their liability from lawsuits arising from their public audits. Their efforts were supported by the Business Roundtable and other conservative groups. Tired of waiting for Congress to act, the auditors are now writing protections into their client engagement agreements in the form of contractual

*Lawsuits by audit clients against their auditors have become more common in the wake of corporate scandals at WorldCom, Inc., Enron Corp. and others.*

provisions that shield the auditors from damages. The provisions typically limit the auditor's potential liability by requiring the client company waive punitive damages and jury-trial rights for company claims against the auditors and submit such disputes to arbitration. Lawsuits by audit clients against their auditors have become more common in the wake of corporate scandals at WorldCom, Inc., Enron Corp. and others. New York-based Cendant Corporation and Birmingham, Alabama-based HealthSouth Corporation each sued Ernst & Young for malpractice, for example, in connection with accounting frauds at those companies. Shareholder groups and federal regulatory agencies oppose efforts to limit

auditor liability, claiming the contract provisions are transparently designed to curb investors' rights to sue, limit their accountability and may lead to less rigorous audits. Investors, such as the AFL-CIO and the Council of Institutional Investors, have complained about the waivers to the Securities and Exchange Commission and the Public Company Accounting Oversight Board, the five-member group that regulates the accounting profession. Critics are concerned that the contractual waivers may violate SEC rules designed to prevent auditors from being too close to their clients. The SEC rules already bar audit clients from entering into contracts agreeing to indemnify their auditors from shareholder litigation. But, the rules do not directly address the waiver agreements. The five federal banking agencies that make up the Federal Financial Institutions Examination Council, including the Federal Reserve Board, have expressed their opposition to the waivers and proposed new regulations that would augment the existing SEC rules by prohibiting banks from agreeing to the waivers. Large investors and public pension funds have also let their opposition be known by withholding votes to approve the company's selection of auditors whenever waiver provisions are written into the audit engagement agreement. Investors believe that potential liability goes a long way toward ensuring high-quality audits and auditor responsibility. In response to their critics, the auditing firms cite the 2002 collapse of Arthur Andersen LLP, after Andersen was convicted on federal charges of obstructing justice in connection with the government's investigation of Enron Corp. The jury found that

*Auditors are now writing protections into their client engagement agreements in the form of contractual provisions that shield the auditors from damages.*

Andersen intentionally destroyed documents related to its long-time client Enron to keep them from federal investigators. The conviction, which the Supreme Court unanimously overturned this year, barred Andersen from public accounting and led to the company's demise. The four remaining public accounting firms claim that, without sufficient protection, a large verdict could put another firm out of business and disrupt the capital markets by further reducing the number of firms qualified to perform public audits. Approximately 80 percent of all publicly traded U.S. companies use one of the four firms, all of which are based in New York. One of the remaining four auditing firms pushing for such limits—KPMG—came dangerously close to extinction recently when it narrowly avoided criminal charges related to its sale of fraudulent tax shelters to wealthy individuals.

*Bloomberg, December 12, 2005. Edited for the Advocate by Benjamin Galdston.*

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## MEDIATING SECURITIES CLASS ACTIONS:

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### The Impact of the PSLRA and the Institutional Investor

The Private Securities Litigation Reform Act (the "PSLRA") has dramatically altered the landscape of securities mediation. Prior to the PSLRA, securities class actions were started by lawyers who represented a single individual or a small group of individuals. Plaintiff's lawyers raced to the courthouse, filed their actions and the litigation proceeded. Institutional investors were rarely, if ever, involved. This led to an interesting dynamic in the settlement process — an entirely different dynamic than the one that exists today. Prior to the PSLRA, the plaintiff's lawyer would prepare for and attend the mediation alone, without input from the client. In a typical pre-PSLRA mediation, the mediator would ask the plaintiff's lawyer to go out in the hall and speak to the client about a proposed offer. Perplexed, the plaintiff's lawyer would respond, "I don't have a client here." "Well then," the mediator would respond, "why don't you go to the restroom, look in a mirror, talk to yourself, and come back here and tell me whether you want to accept the settlement or not." Those are the days of old, the days of the "Wild West," and they are gone.

Now, thanks in part to the PSLRA, institutional investors are actively involved in the litigation and the settlement process. Two positive developments have come about as a result of the PSLRA, and as a result of the institutional investors serving as lead plaintiffs. First, as the statistics demonstrate, settlement values have risen. Second, the degree of involvement by the institutional plaintiff assists in the settlement process. When the defendants attend the mediation and see the actual lead plaintiff also in attendance, with its counsel or a couple of trustees, it helps a great deal. It provides the mediator a tool to use against the defendants to boost the settlement

value. The institutional investor's substantial investment in the stock, and the presence of its representatives at the mediation, tend to resonate with the defendants.

#### Insurance

Today, mediations are tri-partite and involve a whole cast of characters. Among those involved are: the plaintiff's lawyer; the institutional plaintiff, often represented by the fund's counsel and/or one or more trustees; defense counsel; a representative of the defendant; and the insurance companies — each of whom is present with their own lawyer for each layer of insurance.

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This is one of the major problems facing the plaintiff: the layers of insurance and the mosaic rules of insurance. By way of example, assume there are five layers of insurance, \$20 million each. The rule of exhaustion holds that level 2 is not required to pay until level 1 is exhausted; level 3 is not required to pay until level 2 is exhausted, and so on. In addition, if there is a "break" in coverage, meaning that one layer of insurance is insolvent or bankrupt, then the remaining layers



are not required to pay unless the "break" is covered, usually by the defendant company. Now, assuming the case involves damages in excess of \$1 billion, which in essence brings all the layers into play, one of the most difficult jobs facing the mediator is convincing each layer of insurance that they are involved and will have to fund their portion of the settlement. The level five insurer often says, "No way, we don't get touched until \$80 million has been spent." The mediator must convince each level of insurance that the damages are such that its level is involved.

#### Damages

Once all parties and insurance carriers have agreed to mediate, the focus turns to damages. Each side engages experienced, highly qualified experts to make detailed projections as to damages. Plaintiffs should not, however, assume that the damage calculation represents the expected settlement value. In other words, don't assume that an expert comes in and says, "This is how much money was lost as a result of the actions of the defendant," and that is the amount of the settlement. Damages in securities class actions are complicated. Damage calculations are projections based upon statistical analysis and myriad other factors. The case will never settle for the amount of plaintiff's damage calculation.

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# Advocate

## MEDIATING SECURITIES CLASS ACTIONS

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*Mediation of a securities class action is much more complicated than taking plaintiff's and defendant's respective damage numbers and splitting the difference.*

Conversely, defendants' expert will value the case at zero, or next to zero. Of course, the case will never settle for that amount either. Today, defendants typically show up armed with Cornerstone or NERA damage studies or reports, indicating that most cases settle for roughly 2 percent of the plaintiff's damage model. In addition, the Cornerstone or NERA reports often dedicate four or five pages to settlement value and provide a recommendation of the proper settlement amount. However, providing a NERA study to the plaintiff will not get them to agree to the settlement recommendation. This is what mediation is all about—bridging that gap between what the defendant thinks the settlement value is and what the plaintiff thinks the settlement value is. Is there a magic formula? No. Each mediation is different, depending upon the personalities of the people involved, the viability of the company, what the insurance company is willing to pay, and various other case-specific factors.

Indeed, mediation of a securities class action is much more complicated than taking plaintiff's and defendant's respective damage numbers and splitting the difference. All parties, including the mediator, must analyze all of the factors which go into a settlement. The defendants' ability to pay is a primary focus. The ability to pay comes in the first

instance from the insurance company. If the defendant is bankrupt, then the insurance proceeds are likely the only source of money available to fund a settlement. If the officers and directors are defendants, generally speaking, they will not have the resources to make anything other than a token payment.

To illustrate, assume plaintiff's case of securities fraud is well developed, but the defendant is in bankruptcy with \$50 million in insurance. Regardless of the total damages, whether it is a billion or ten billion dollars, the plaintiff will never get that much because it simply is not there for the asking. Under these circumstances, the plaintiff wants to get whatever insurance proceeds are available. But, these insurance policies are "wasting" policies. The costs of defense counsel's fees and expenses are taken off the top and "waste" away at the policy. Therefore, as the litigation progresses, the defense lawyers are going through the \$50 million, submitting their bills, and reducing the overall available money for settlement. Under these circumstances, it is important to keep in mind that the further the litigation progresses, the less and less money is available for settlement.

Well, this sounds easy. If the facts are excellent and there is \$45 million left in insurance, one would expect the insur-

ance companies to agree to settle. It is not that easy, however. The insurance companies have their own issues to dispute and are not eager to pay the policy limits. If the company is bankrupt, the insurance company is now in a situation where theirs is the only available money to fund a settlement. They will usually demand some consideration, putting the plaintiffs in a quandary of either agreeing to give some consideration—i.e., a lesser settlement amount—or continuing to litigate and allowing the policy to burn down by itself.

### The Securities Lawyers

This is where practicality and experienced securities class action lawyers become so important. And while the plaintiff may feel that its case is strong and wants to litigate to the end, doing so would not be advantageous for the lead plaintiff or the class it represents. Determining the amount of consideration to be given to the carrier, if any, is far from an exact science. Securities class actions require expertise and individuals who truly understand what is happening— who feel the pulse of it, who are able to react to it, and who are able to deal with it in a settlement context.

Not every case, however, is a *WorldCom* or an *Enron*, where billions of dollars will be recovered for investors. If there is a viable company, there is a much higher probability of a larger settlement, but the majority of cases have much lower damage figures and a much lower ability to pay. The plaintiff, along with its lawyer, must work within the constraints of the facts of the particular case. Additionally, the uncertainty and unpredictability of trial is always a key factor. Trials are not simple matters of presenting one's case and assuring victory. Both sides must understand that, as good as their case may be, they can lose. Nothing is a "slam dunk." The plaintiff must counsel with its experienced lawyers—that is what they are there for.



# Advocate

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## The Mediator

It is important to remember that every mediator comes to mediation with his or her own style. Some like to sit around and exchange thoughts, have one side make a presentation, then the other. Then, after the parties have gotten mad at each other, the mediator splits them up into two separate rooms. Other mediators prefer to break the parties up into separate rooms at the outset, allowing each side to speak freely and openly with the mediator, but not with the other side. Regardless of style, the mediator has read the pre-mediation briefs and has a good sense of the facts and issues at hand. Based upon experience, and the information provided in advance by the parties, the mediator can usually

sense where the case is going before the mediation begins. The mediator looks at the insurance proceeds, the viability of the company, the plaintiff's damages and demands, the defendant's reports, and the judicial decisions in the case. The mediator is not, however, prepared to try the case. Rather, the mediator views the case through a peephole, seeing only the parts the parties have revealed. It is from behind this "peephole" that the "captain" attempts to navigate the parties towards a mutually agreeable and beneficial resolution.

There is one thing to always keep in mind in settling cases: it is not a victory. It is something which makes one side reasonably unhappy and makes the other reasonably happy. Or vice versa. The settlement is usually somewhere in the middle. Not necessarily right in the middle, but somewhere between what the parties and their attorneys believe the case is worth.

Mediating securities class actions is really quite unique. It is not regular law, it is not like regular settlements, it is not merely claims adjudication. It has evolved a great deal since the passage of the PSLRA and, to be effectively administered, requires experience and expertise — from the mediator, the parties and their counsel.

*The Honorable Nicholas Politan is a retired Judge of the United States District Court for the District of New Jersey (1987 to 2002). Prior to his service as a federal judge, he was a lawyer in private practice, and also an owner and chairman of a banking institution. During his time on the bench and since retiring, he has overseen the successful settlement, mediation and arbitration of hundreds of securities class actions. In addition, he has been appointed Special Master by various Federal Courts in complex litigation. Judge Politan is the recipient of numerous awards for his service on the bench.*

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We welcome input from our readers.

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