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Mirror, Mirror On The Wall, Give Me The Lowest Price Of All

(Corporate Greed Redux)

by Noam Mandel

Imagine you could travel back in time to pick your stocks. Just think what a successful investor you would be! You could sit comfortably in your living room reviewing old editions of *The Wall Street Journal,* identifying equities that used to trade low and now trade high. You could then simply travel back to a day when your chosen stock was at or near its absolute low and buy a nice position. Fast-forward to the present and you've got a handsome locked-in profit — all because you were able to buy stocks in the past.

Buying stocks with 20-20 hindsight is not, however, a privilege generally available to any investor. Indeed, recent developments make clear that the capacity to purchase stocks retroactively

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Contesting Attorneys' Fees In Class Actions

A Public Pension Fund Fiduciary Responsibility

Consistent with the mission of the Advocate *to present articles from individuals active in the institutional investor community that represent widely varying points of view, we publish the below article written by Gerald Gornish.*

By Gerald Gornish

Mr. Gornish is the Chief Counsel of the Pennsylvania Public School Employees' Retirement System. The views expressed herein are the views of the author only and do not necessarily reflect the views of the Pennsylvania Public School Employees' Retirement System or the Commonwealth of Pennsylvania.

In a recent edition of this newsletter, Peter M. Saparoff offered many sound suggestions to institutional investors regarding actions they should take in cases in which they are not lead plaintiff to be certain they are fulfilling their fiduciary duties.

One action he did not include, which I believe institutional investors have a responsibility to consider, is a close review of the attorneys' fees sought by counsel for the plaintiff class when a case settles. Institutions should review both the *percentage* of recovery and the *amount* of attorneys' fees requested in each

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seems reserved for the chosen few—the senior managers, directors and other insiders who, through their domination of the machinery of the companies they manage, seem able to extract compensation on whatever terms they desire. Of course, these individuals aren't actually traveling back in time to purchase stocks. Rather, for many years, insiders at corporations across the country did the next best thing: ***backdated their stock options.*** The scandal has sparked wide-ranging investigations by the Securities and Exchange Commission ("SEC"), Department of Justice and other federal regulators, and has drawn the ire of institutional investors, many of whom have initiated civil lawsuits.

A stock option is a right to buy a particular stock at a predetermined fixed price, called the "exercise" or "strike" price. When the stock's market price is higher than its strike price, the option is "in the money" and, if vested, the option holder may exercise the option at a profit, paying the strike price and pocketing the difference. Thus, the lower the exercise price, the more profitable the option. When public companies issue stock options as compensation, they must do so according to the terms of formal stock options plans that are publicly filed and approved by shareholders. Importantly, these plans almost universally require that stock options issued to insiders carry exercise prices no lower than the market price of the underlying stock on the day the options are granted.

A review of stock option grants to executives at public companies across the United States reveals a disturbing trend: since at least the mid-1990s, executives and other insiders at an alarming number of public companies seem to have regularly received stock options on dates when the public trading price of the stock was unusually low — typically at or near annual or periodic lows, immediately before a substantial run-up in the stock price or immediately after a sharp decline. Indeed, one need only plot the

Inside Look

Max Berger

From WorldCom's historic and record-setting collapse to widespread market timing in the trillion dollar mutual fund industry, corporate scandals continue unabated. Most recently, it has come to light that insiders at corporations across the country have, for years, been backdating stock options. Just when we thought we've seen it all, we learn of the disturbing trend of corporate insiders regularly receiving stock options on dates when the public trading price of the stock was at or near annual or periodic lows. The abusive practice has sparked wide-ranging investigations by the SEC, the Department of Justice and other federal regulators, and has drawn the ire of institutional investors, many of whom have initiated civil lawsuits.

In "Mirror, Mirror on the Wall, Give Me the Lowest Price of All (Corporate Greed Redux)," BLB&G Associate Noam Mandel discusses the recent extraordinary revelations surrounding the secret backdating of stock options by hundreds of companies and executives. Noam shows us how the practice is not just illegal but, also, wastes valuable corporate assets and negatively impacts a company's financial statements. As he demonstrates through egregious examples at UnitedHealth and Affiliated Computer, the regular backdating of stock option grants could only have been achieved by corporate boards failing to provide the governance and oversight for which they are elected. To date, an astonishing number of investigations and lawsuits have commenced, with additional revelations and lawsuits occurring on an almost daily basis.

At the *Advocate*, we strive to present articles from individuals active in the institutional investor community even though those articles may not reflect the views of the editors. In that spirit, we are pleased to publish "Contesting Attorneys' Fees in Class Actions: a Public Pension Fund's Fiduciary Responsibility." In this article, Gerald Gornish, General Counsel of the Pennsylvania Public School Employees' Retirement System provides his opinion regarding the fiduciary duties of institutional investors to review fees sought by counsel for the plaintiff class when a case settles.

In his regular column "Eye on the Issues," BLB&G Associate Ben Galdston has, again, provided a perceptive compilation of some of the most significant developments in the areas of securities fraud and corporate governance. This quarter, Ben monitors the efforts of regulators and institutional investors to push corporate governance reform and scrutinize executive compensation. Ben also reports on the guilty verdicts in *Enron*, the massive overstatement of income at Fannie Mae, and much more.

As always, we endeavor to make the *Advocate* informative, helpful and a pleasure to read. We have enjoyed bringing this issue to you and welcome the many comments, questions and input we receive from our readers.

Since at least the mid-1990s, executives and other insiders at an alarming number of public companies seem to have regularly received stock options on dates when the public trading price of the stock was unusually low-typically at or near annual or periodic lows, immediately before a substantial run-up in the stock price, or immediately after a sharp decline.

claimed grant dates on line graphs of stock prices to note the remarkable consistency with which grants appear at the bottom of "valleys" or other periodic lows in the stock price. These all too frequent patterns seem to trail off after August 2002, when the SEC promulgated rules under Sarbanes-Oxley requiring disclosure of stock option grants within two business days.

Common sense alone suggests that there is more than simple coincidence behind the highly auspicious — and suspicious — timing of these stock option grants. As an example, and in what is perhaps the most appalling fact pattern yet to emerge from the burgeoning backdating scandal and associated investigations, between 1997 and 2002 the current chief executive and chief operating officers of UnitedHealth Group, Inc. ("UnitedHealth") — the prominent Minnesota-based healthcare provider — received stock option grants on the single lowest trading day of the year four years in a row, and within pennies of that low in the other two years. As of the close of UnitedHealth's last fiscal year, these two officers by themselves owned stock options worth in excess of $2 billion — much of which was directly attributable to the low-cost options they received during these years.

Patterns of options grants like these are simply too good to be true. In order to accept them, one would have to believe that corporate insiders are actually luckier than the rest of us. In fact — and as a gauge of the self-entitled reception that shareholders may expect to receive from insiders who benefited from suspiciously timed grants — one chief executive officer offered that precise explanation for the favorable timing of his stock option grants. When asked by *The Wall Street Journal* about the suspicious time-pattern of his stock options, the now former chief executive of Affiliated Computer Services, Inc. ("Affiliated Computer"), a man ironically named Mr. Rich, explained to the newspaper that it was a product of "blind luck."

Some might call that "shareholder relations." We call it chutzpah — a high-handed insult to the intelligence of shareholders — and the statistics back that conclusion to the hilt. Statistical studies conducted by *The Wall Street Journal,* as well as several academics and securities analysts, demonstrate that it is virtually impossible for the fortuitous patterns of stock option grants claimed by numerous companies to have occurred randomly. For example, *The Wall Street Journal,* working with several professors of finance and statistics, concluded that the likelihood of grants to UnitedHealth's chief executive officer occurring as claimed were one in 200 million. The same analysis with respect to stock options granted to the now former chief executive of Affiliated Computer concluded that the odds were even lower — one in 300 billion. By contrast, according to the same article, "[t]he odds of winning the multistate Powerball lottery with a $1 ticket are one in 146 million."

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Securities analysts have begun to take note of this phenomenon as well. For example, in response to the recent increased scrutiny of stock option grant activity, Merrill Lynch published a report entitled "Options Pricing — Hindsight is 20/20," in which it analyzed options grant activity among United States semiconductor companies. The report focused on the extent to which stock-price performance immediately following options grants exceeds stock price performance over similar periods. As the report explained, "[t]heoretically, companies should not be generating systematic excess return in comparison to other investors as a result of how options pricing events are timed." In other words, if the timing of options grants is not manipulated, returns immediately following the grants should, on average, be similar to returns over any similar period. The report explained further, "if the timing of options grants is an arm's length process, and companies haven't systematically taken advantage of their ability to backdate options...there shouldn't be any difference between the two measures."

Merrill Lynch concluded that, in many cases, there was a substantial deviation between the two measures. In the case of semiconductor company Maxim

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Integrated Products, Inc. ("Maxim"), Merrill Lynch found that returns during the 20 days immediately following option grants to Maxim executives were approximately 14%, which translated to an annualized return of 243%. The annualized returns for an arm's length investor in Maxim during the same period were only 29%. When insiders' market returns are nearly ten times those achieved by arm's length investors, there is plainly something more disreputable than "blind luck" at play.

The backdating scandal is but the latest in a long line of outrages in the area of executive compensation at public companies—outrages that shareholders have been largely powerless to combat. Courts in Delaware and other states have traditionally reviewed executive compensation under the "business judgment rule," a standard that leaves compensation to directors' business discretion and renders it very difficult for the investing public to challenge even the most absurd and excessive compensation packages. Disney shareholders' unsuccessful challenge to Michael Ovitz's $140 million package after only fourteen months of failed service as the company's president is an infamous example. The essentially unhindered authority of corporate boards to determine executive compensation has become so ingrained that managers of public companies now routinely extract tens and often hundreds of millions of dollars in unjustifiable compensation in full view of their shareholders — and with complete impunity.

The essentially unhindered authority of corporate boards to determine executive compensation has become so ingrained that managers of public companies now routinely extract tens and often hundreds of millions of dollars in unjustifiable compensation in full view of their shareholders — and with complete impunity.

In this context, the revelations about stock options backdating add insult to injury, and underscore the utter lack of effective governance over executive compensation practices that exists in the United States today. The regular backdating of stock option grants could only have been achieved through incredible failures by corporate boards — and compensation committees in particular — to live up to their fiduciary obligations and provide the governance and oversight for which they are ostensibly elected. In another egregious example from UnitedHealth, the chief executive's employment contract contained a highly unusual provision allowing him to choose the dates of the grants by "oral notification" to the chairman of UnitedHealth's compensation committee — a provision described in *The Wall Street Journal* as a "thinly disguised attempt to pick the lowest grant price possible." The deceptive practice of backdating options thus embodies a breach not only of the established duties of corporate fiduciaries, but of the trust that the investing public necessarily places in the good faith and commitment of their elected representatives on corporate boards.

The backdating scandal is also a symptom of the self-interested notion long held among many corporate insiders and their advocates that stock options are basically free — costless enterprises with no real price tag. For years an analogous debate regarding the proper accounting treatment of stock option grants raged, with corporate insiders insisting against all reason that stock options granted as compensation to executives have no real value and, therefore, should not be treated as expenses. Indeed, as written in the

By The Numbers...

$2 billion:
Amount of as yet unexercised stock options owned by CEO and COO of UnitedHealth Group (UNH) at end of FY 2005.

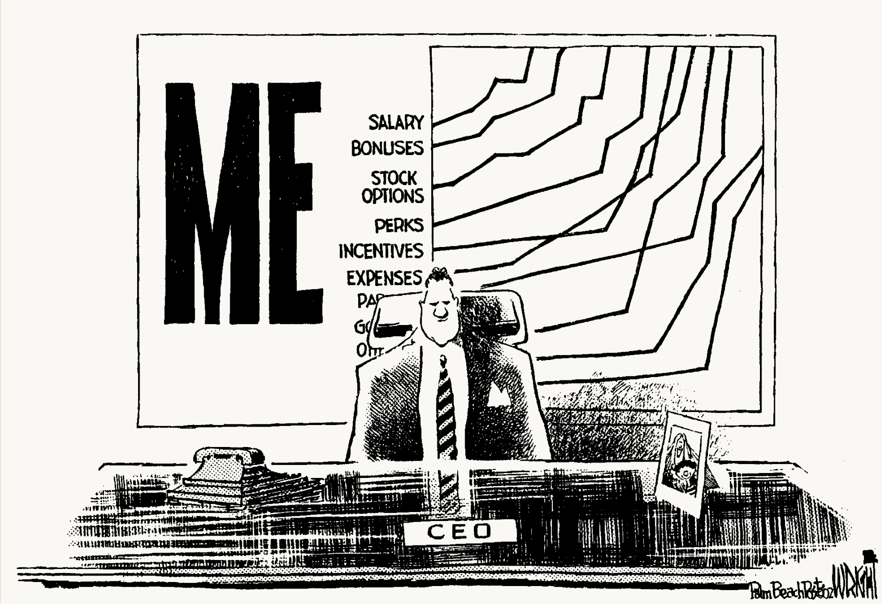
1997 to 2002:
Years in which UNH CEO and COO somehow managed to receive stock option grants on extremely beneficial days — the single lowest trading day of the year four years in a row, and within pennies of that low the other two years.

1 in 200 million:
As published in *The Wall Street Journal*, chances of these option grants actually occurring as claimed.

pages of *Business Week* magazine almost fifteen years ago:

> Nothing has contributed more to the disjunction between pay and performance than the stock option. When it came into vogue after Congress granted favorable tax treatment in 1950, few could imagine the impact that stock options would eventually have on the compensation game. In the early days, stock-option awards were fairly conservative, even miserly. But since the late 1960s, the average size of an option grant has tripled, as boards began doling out stock options like Monopoly money. In 1989, Walt Disney Co.'s Michael D. Eisner was handed a then unprecedented 2 million options — a record broken a year later when Anthony J. F. O'Reilly, chairman of H.J. Heinz Co., received a 4 million grant in one fell swoop.... The sad truth is that accounting rules make options as free as those tinted dollars in the Parker Brothers game.

While the size of these grants might appear quaint in comparison to today's standards, and although the debate over accounting treatment was recently resolved in favor of expensing stock options, the tendency to accord stock options the cavalier treatment reserved for things without impact on the bottom line remains. But stock options are not Monopoly money—they represent real corporate obligations with a real impact on a company's finances and financial reporting. And, as described below, backdating stock options harms corporations and their shareholders in several key respects.



Nothing has contributed more to the disjunction between pay and performance than the stock option. When it came into vogue after Congress granted favorable tax treatment in 1950, few could imagine the impact that stock options would eventually have on the compensation game.

Stock option backdating causes a direct and continuing waste of valuable corporate assets. Public companies are the counterparties of stock option contracts with members of their management, and the gains obtained by insiders through exercising backdated options are therefore siphoned, on a dollar-for-dollar basis, directly from the companies and their shareholders. A simple hypothetical example should clarify the point.

Assume that the chief executive officer of X Corp today receives a grant of 100,000 options to purchase X Corp stock, which is today trading at $100 per share. Three months ago, however, X Corp stock was trading at $50 per share. Finally, assume that the stock price increases to $200 per share, at which time the CEO exercises the options. If the stock options were granted at the appropriate exercise price of $100, the CEO will need to pay the company $100 per share to exercise those options, for a total payment of $10 million ($100 x 100,000). If, on the other hand, the stock options are backdated to the date three months ago when the stock price was at $50, the CEO will be required to pay the company only $5 million ($50 x 100,000) to obtain the same amount of shares — a loss of $5 million to the company. Thus, by backdating the options, X Corp's chief executive obtains a sweetheart deal — $20 million worth of stock at half price without having to put in the sweat equity required to legitimately enhance the performance of the company and the stock price for the benefit of all shareholders.

The practice of backdating grants of stock options also causes companies to overstate earnings in their publicly filed financial statements. The relevant accounting rules require that, when a company grants a stock option with an exercise price below the value of the underlying stock *(i.e.,* an "in the money" option), the company must recognize the difference in value as an expense on its financial statements, and charge that difference to earnings. Returning to our hypothetical, when X Corp. grants the

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Eye on the Issues

LEGISLATIVE/REGULATORY UPDATES AND RECENT DECISIONS OF INTEREST

By Benjamin Galdston

Enron CEO Ken Lay Dies Awaiting Sentencing

On July 5, 2006, Enron founder Kenneth Lay died at an Aspen, Colorado vacation home after suffering a heart attack. Lay was awaiting sentencing for his role in the massive Enron fraud. On May 25, 2006, a Texas federal jury found Lay and former Enron CEO Jeffrey Skilling guilty of wire fraud and conspiracy to commit securities fraud in connection with one of the biggest corporate scandals in U.S. history. Lay was also convicted of bank fraud in a subsequent related criminal trial. Both Lay and Skilling sold vast amounts of Enron stock before the collapse. Lay took home $220 million from the sale of Enron shares from 1999 through 2001, while Skilling sold shares worth $150 million. When Enron—the seventh largest company in the U.S.—imploded in 2001, it wiped out more than $60 billion in market value, almost $2.1 billion in retirement savings and 5,600 jobs. Skilling faces a lengthy prison term, with sentencing scheduled for the end of October. Lay and Skilling blamed Enron's CFO Andrew Fastow for the company's downfall, and pointed to short-sellers and the financial media, who they claim spread negative rumors and caused the stock price to tumble. Jurors were not persuaded, returning guilty verdicts on all counts for Lay and 19 of 28 counts for Skilling. *Washington Post, May 25, 2006; New York Times, July 5, 2006.*

Executive Compensation Under The Microscope

Regulators and shareholders are increasingly calling for heightened scrutiny of executive compensation and even demanding repayment of performance-based compensation earned during periods of fraudulent accounting practices. The California Public Employees' Retirement System recommends that companies adopt claw-back policies for performance-based compensation in its guidelines for good corporate governance and has indicated it will withhold its votes for four directors of United Health Group, Inc. in protest over excessive executive compensation practices and back-dated stock option grants. The Sarbanes-Oxley Act of 2002 provides that a company can "claw back" bonuses given to top executives during a period if the company subsequently restates its financial results for that period. However, few companies actually demand that executives forfeit bonuses. For example, in April, the former CEO of Computer Associates pled guilty to charges that he inflated the company's sales in 1999 and 2000, but it is unclear whether he will have to return the more than $300 million in performance-related bonuses. Most executives do not voluntarily return their ill-gotten gains, often forcing protracted legal battles. In January, an Alabama court ruled that former HealthSouth chief executive Richard Scrushy must repay $48 million in bonuses he received during the Company's period of inflated earnings. Scrushy is appealing the decision. *Fortune, May 2, 2006; Boston Globe, June 6, 2006.*

"Arrogant And Unethical" Fannie Mae Inflated Earnings By $11 Billion

Fannie Mae has admitted overstating income and capital by $11 billion between 1998 and 2004. In May, the agency charged with regulatory oversight over Fannie Mae, issued a scathing 348-page report, which concluded that Fannie Mae senior management deliberately manipulated the company's accounting to inflate earnings and trigger bonuses, and that employees "stonewalled" government investigators. The report cited an "arrogant and unethical" corporate culture and said that the company used its enormous power in Washington to lobby Congress in an effort to interfere with the federal investigation. Fannie Mae agreed to pay a $400 million penalty and freeze the growth of its $720 billion-plus loan portfolio to settle the government's inquiry. Regulators may pursue repayment of as much as $52 million of former chief executive and Chairman Franklin Raines' $90 million compensation that was linked to the inflated earnings. Current Fannie Mae chief executive officer Daniel Mudd has indicated that he would repay some of his past compensation if its board demands repayment. *Wall Street Journal, June 8, 2006; New York Times, June 9, 2006.*

Stock Exchanges Go International

In June, the NYSE Group, Inc., the parent of the New York Stock Exchange, announced plans to merge with the European stock exchange operator Euronext NV. The $10 billion deal will create the first trans-Atlantic exchange and the biggest exchange in the world. The merged company, called NYSE Euronext, is already in discussions with Italy's main stock exchange for further European consolidation. The NYSE Group beat out Germany's Deutsche Börse AG in fierce bidding. Other exchanges are following suit, jockeying for position to maintain or expand their share of the global pool of investment money. Nasdaq Stock Market, Inc. has managed to buy up a 25% stake in London Stock Exchange, PLC and recently announced a new price-discounting plan designed to attract new business. Under the plan, the exchange gives brokers deep discounts if they agree to trade not only Nasdaq-listed stocks via Nasdaq, but also trade NYSE-traded stocks, as well. The consolidation activity is largely seen as a response to the declining profitability in the traditional business of trading stocks, which has become less lucrative because of advances in technology, and a desire to tap into global wealth. *AP Newswire, June 1, 2006; Wall Street Journal, June 3-4, 2006.*

Federal Court Rules That SEC Has Limited Authority Over Hedge Funds

A new rule requiring most hedge fund managers to register with the SEC was invalidated by the United States Court of Appeals for the District of Columbia Circuit. A three-judge panel ruled unanimously that the SEC exceeded its power by attempting to force hedge fund managers to register with the commission. The rule, which took effect in February, also required hedge fund managers to open their books to routine inspections by SEC examiners. The SEC adopted the rule to address the significant boom in the hedge-fund business. Recent estimates find that there are nearly 9,000 funds with assets totalling over $1 trillion, a huge increase from about 600 funds with about $39 billion in assets in 1990. Hedge funds also have become popular investment tools used by pension funds, 401(k) plans and endowments to improve returns while interest rates are low and stock market performance lags. Some critics believe that the lackluster stock market performance is due to capital movement away from equities markets into hedge funds. Because hedge funds are largely unregulated, critics believe they are ripe for abuse. *New York Times, June 24, 2006.*

SEC Chairman Hints At Real-Time Information Instead Of Quarterly Reporting

In a keynote address in May at an American Enterprise Institute conference, SEC Chairman Christopher Cox questioned the traditional quarterly corporate filing, suggesting that corporate financial information in this electronic age could be available to shareholders and investors in "real time." Section 409 of the Sarbanes-Oxley Act of 2002 requires that reporting companies must "disclose to the public on a rapid and current basis" information concerning material changes in the financial conditions and operations, rather than wait until the end-of-quarter report, but sets no deadline and does not specify how such disclosure must be made. Electronic media provides an ideal solution, allowing companies to report important financial information on a company website, for example, in real time. Proponents of real-time reporting believe that more timely and accessible information would tend to focus investors on the long-term goals and growth, rather than on quarterly trends. Many companies already offer shareholders the option of receiving their proxy statements via electronic mail, saving on printing and postage expenses. *Securities Regulation & Law Report, June 5, 2006.*

Shareholder Activists Continue To Push Important Reforms

Large shareholders increasingly are taking their concerns directly to the board of directors when corporations fail to adopt adequate governance reform from within. Recently, for example, in response to shareholder demands for better transparency, a small but growing number of companies have agreed to disclose their political donations. Other companies, though, are less responsive. For example, General Motors shareholders who were dissatisfied with the company's chief executive Rick Wagoner, recently put six proposals on the agenda for GM's 98th annual stockholders meeting in Wilmington, Delaware. Wagoner is roundly criticized for failing to decisively turn the company around while GM also posted a staggering $10.6 billion loss, causing many shareholders to call for his ouster. Four of the six proposals submitted by GM shareholders are aimed at weakening Wagoner's and the GM board's influence, including splitting the CEO and chairman positions, recouping bonuses awarded to executives based on the restated financial results, and others. The proxy advisory firm Institutional Shareholder Services publicly voiced support for the GM shareholder proposals, citing the importance of better protection for shareholders and increased accountability for management. Shareholders of other companies who are dissatisfied with current management have registered their displeasure by withholding their votes for directors at the annual shareholder meetings. In April, investors holding more than one-quarter of the shares of the New York Times Company withheld their votes, including Morgan Stanley Investment Management, the company's fourth-largest shareholder, with 5.8% of the stock. In 2004, 43% of Walt Disney Company shareholders withheld their votes when asked to re-elect Michael Eisner to the board. *CNNMoney, June 4, 2006; AP Newswire, May 1, 2006.*

Study Finds Material Weaknesses In Internal Controls Down But Late Filings Up

A recent study by Moody's Investors Service has found that the number of companies reporting material weaknesses in internal controls over financial reporting is down for the first time since 2004, when the Sarbanes-Oxley Act of 2002 first required such reporting. Seventy-five companies reported material weaknesses, down over 35% from 2004. However, the study also found that the number of delinquent filers rose from 21 in 2004 to 29 in 2005, with 11 companies filing late in both years. Many companies point to the additional reporting and compliance requirements imposed under Sarbanes-Oxley as contributing to tardy filings. In April, an SEC advisory committee recommended that many smaller companies be exempted from key provisions of the Act. In one of the more controversial recommendations, the panel urged that most public companies be exempted from Section 404 of the Sarbanes-Oxley Act, which requires a comprehensive review of all financial reporting procedures and an overhaul of any areas of material weakness. *Complianceweek.com, May 23, 2006; Final Report of the Advisory Committee on Smaller Public Companies to the SEC, April 23, 2006.*

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CONTESTING ATTORNEYS' FEES

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case, and object to them where they appear excessive. Indeed, while the Saparoff article addresses the difficulties involved in second-guessing the *amount of a settlement* in which an institution has not been intimately involved during negotiations, the *reasonableness of a fee* sought by counsel can more easily be evaluated by institutions by comparing it to the firm's lodestar.

I say this fully recognizing that courts have justifiably moved away from utilizing a lodestar approach to determining the *amount* of attorneys' fees to be awarded. Courts have asserted that doing so converts their role into bean counters and encourages class counsel to inflate the amount of work devoted to the case. Add to that an hourly rate that is not commonly the product of negotiation since it is not the basis on which plaintiff's counsel is typically compensated in these cases. Be that as it may, the lodestar — with all its deficiencies — still represents the only quasi-objective basis to check the reasonableness of the amount sought under a percentage contingency.

Why is the lodestar relevant? Think about it. Most successful corporate law firms bill on an hourly-rate basis and are generally delighted to receive their undiscounted hourly rates. Even if class counsel receives nothing in 50% of the cases counsel undertakes, a strictly mathematical solution would provide only for two times the lodestar to make counsel whole. A simple lodestar multiple calculation and comparison will thus provide a quick method of determining whether the fee sought seems presumptively fair or whether further review is necessary.

Any questions as to the appropriateness of the fee can and should be directed to class counsel, virtually all of whom, in my experience, have been very forthcoming with details and explanations.

In addition to the percentage sought and the lodestar multiple, the institution should ascertain if there is any feature in the case that makes it other than a plain vanilla securities litigation matter, which would justify either a higher or lower percentage or lodestar multiple. Factors to consider have been developed in such cases as *In re Prudential Ins. Co.*, 148 F.3d 283, 336-40 (3d Cir. 1998) and *Gunter v. Ridgewood Energy Corp.*, 223 F.3d 190, 195-96 (3d Cir. 2000). Any questions as to the appropriateness of the fee can and should be directed to class counsel, virtually all of whom, in my experience, have been very forthcoming with details and explanations. If they do not respond, a request for discovery under Fed. R. Civ. P. 23 (h)(2), would be appropriate.

Will such efforts, including the filing of objections, produce a benefit to the class? I believe so. There is both academic and anecdotal support.

Although courts initially latched on to the personal injury model of a one-third contingent fee, often producing a tremendous windfall to class counsel, the advent of the mega cases, commencing with *Cendant*, demonstrated the unreasonableness of those high percentages and served also to put the brakes on automatic court approval. Indeed, whereas in 2000, an article on legal fees by Keith L. Johnson and Douglas M. Hagerman pointed out that the average fees in securities class action matters was about 31% of recoveries, with the growth of public pension and other institutional lead plaintiffs, the mean has declined considerably.

A recent study by Professor Michael A. Perino (*Markets and Monitors: The Impact of Competition and Experience on Attorneys' Fees in Securities Class Actions*, St. John's University School of Law Legal Studies Research Paper Series, Paper #06-0034 (Jan. 2006)) found that attorneys' fee requests and awards have dropped significantly since public pension funds began to take the lead role in securities class actions. He determined that between April 1997 and May 2005, the mean attorneys' fee was

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Quarterly Quote…

"Right now, private actions are more than, in traditional SEC words, 'a necessary supplement to the Commission's efforts'; **private actions are absolutely essential** if our securities regulation system is to work."

Former SEC Commissioner Harvey J. Goldschmid at a May 5, 2006 conference sponsored by the Institute for Law and Economic Policy

A recent study found that attorneys' fee requests and awards have dropped significantly since public pension funds began to take the lead role in securities class actions. [The study] determined that between April 1997 and May 2005, the mean attorneys' fee was approximately 20% of the total recovery pool in cases with a public pension fund lead plaintiff compared to 27% in cases of other lead plaintiffs.

approximately 20% of the total recovery pool in cases with a public pension fund lead plaintiff compared to 27% in cases of other lead plaintiffs.

It has also been demonstrated by Theodore Eisenberg and Geoffrey P. Miller, *Attorney Fees in Class Action Settlements: An Empirical Study,* 1 Journal of Empirical Legal Studies 27-78 (2004), that the mean fee in common fund cases is well below the widely quoted one-third figure; they calculated the mean fee in class action data sets between 1993 and 2002 as 21.9% and the mean for securities cases at 24.1%. They also observed, as one would expect, that the percentage of recovery decreases as the amount of the settlement rises. They go so far as to claim that client recoveries generally explain the pattern of awards better than the lodestar and even suggest that the time and expense of a lodestar calculation may be wasteful.

I respectfully disagree with this latter conclusion. The lodestar is the only quasi-objective basis for determining whether the fee is reasonable. I believe that their extrapolated conclusion from data in their study — based solely on the value of a case rather than the efforts and legal acumen that went into producing the result — is too facile with respect to what a *reasonable fee* should be.

Anecdotal results also support the proposition that the efforts of institutions have produced fee reductions. As members of the plaintiff class, including public pension funds, have begun to object to the higher fee percentages sought, the courts have begun to scrutinize these requests more closely and have often reduced the fees requested to amounts that are substantially less than the traditional one-third. This is not a universal result. The experience of my agency, which entails principally the submission of written objections in a number of cases, has produced both reductions (in fees) and rejections (of our objections).

Some recent successful cases:

In re Infospace, Inc. Sec. Litig., 330 F. Supp. 2d 1203 (W.D. Wash. 2004), the court, following receipt of objections from public employee retirement systems and argument by Wayne Schneider, Chief Counsel of the New York State Teachers' Retirement System ("NYSTRS"), awarded a fee representing less than 12% of the settlement fund of $34.3 million rather than the 25% fee requested;

In re Honeywell International Inc. Sec. Litig., Lead Case No. 2:00 CV 036 05 (DRD) (D.N.J. 2004) (in which my agency joined NYSTRS in an objection and presented oral argument), the fee request of 25% of a $100 million settlement was reduced to 20%;

In re Veritas Software Corporation Sec. Litig., Case No. C-03-0283-MMC (N.D. Cal. 2005) (in which my agency joined in an objection), the fee request of 23.23% was reduced to a fee of 17% of the settlement (representing nevertheless 4 times the lodestar).

In addition, the author has been successful in negotiating reductions in fees without the necessity of filing an objection after reviewing data and discussing the merits with class counsel.

Moreover, the courts have themselves begun to scrutinize requests and have lowered fees. See:

Klein ex rel Sicor Inc. v. Salvi, 2004 U.S. Dist. LEXIS 4844 (S.D.N.Y. Mar. 26, 2004), aff'd 115 Fed. Appx. 515 (2d Cir. 2004),

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CONTESTING ATTORNEYS' FEES

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where the court awarded a fee of 8% of the $10,750,000 settlement — a multiple of 1.43 times the allowed lodestar;

In re Twinlab Corp. Sec. Litig., 187 F. Supp. 2d 80, 88 (E.D.N.Y. 2002), where the court awarded a 12% fee on a $26.5 million settlement;

In re Cylink Sec. Litig., 274 F. Supp. 2d 1109, 1115-16 (N.D. Cal. 2003), where the court determined that a fee of 16% of $6.2 million was "fair, adequate and reasonable;"

And *In re Bristol-Myers Squibb Sec. Litig.*, 361 F. Supp. 2d. 229 (S.D.N.Y. 2005), where the court rejected a fee request of 7.5% of the $300 million settlement and instead awarded a fee of some $11 million (less than 4%), representing a lodestar multiplier of 2.29 times.

Professor Perino also suggests that courts should encourage institutional investors to file objections to excessive fees. He believes that objections may be particularly useful in smaller cases in which institutions are unlikely to participate as lead plaintiffs, noting that these are the cases in which objections aimed at reducing fees are likely to have the smallest impact, thereby providing a disincentive for public pension funds to take action. To remedy this he suggests fully compensating institutions for their cost in pursuing such objections and to award them some greater portion of the savings and attorneys' fees.

I would disagree with giving a greater proportion of the savings to an objector by analogy to the PSLRA's prohibition against the lead plaintiff recovering more than other members of the class; but institutions should be entitled to reimbursement for their out-of-pocket costs. In the cases in which my agency has objected and successfully contributed to reductions in fees, we have not sought any reimbursement. Certainly if we incurred significant travel costs to attend a hearing, reimbursement would be appropriate; but for the most part we have relied on written objections or have appeared in District Courts that are within driving distance.

In conclusion, class counsel incur a risk in undertaking representation of the class and are entitled to reasonable compensation for doing so. Institutional investors have a fiduciary obligation to make sure the fees are, in fact, reasonable — whether as lead plaintiff negotiating the fee, as recent evidence suggests is the case, or as a member of the class objecting to the fee. To put it bluntly: every dollar paid to counsel is a dollar taken from the class.

BLB&G in the News!

BLB&G Ranked "Best in the Field" in Chambers 2006 Guide to America's Leading Lawyers for Business

June 2006 — BLB&G was given the top ranking in the field of plaintiff securities litigation in *Chambers and Partners'* ("Chambers") *2006 Guide to America's Leading Lawyers for Business*. This is the first time that Chambers, the publisher of several globally respected guides to law firms and lawyers, has included this practice area: "Litigation – Securities Mainly Plaintiff." According to Chambers, "The inclusion of the table for the first time this year recognizes the importance of a select number of firms who do high-profile work in the area." Chambers' rankings assess the reputations and expertise of business lawyers in 175 countries across the world and are compiled based on thousands of in-depth interviews conducted with clients.

According to Chambers, "Clients are unanimous in their opinion that Bernstein Litowitz gives 'the best advice in the field.'" Visit www.blbglaw.com to read the full text of the BLB&G profile from *Chambers 2006 Guide*.

Lawdragon Magazine Names Four BLB&G Partners to its List of "New Stars"

July 2006 — Four BLB&G Partners were named to the inaugural listing of *Lawdragon's* 500 "New Stars, New Worlds." *Lawdragon*, a national legal publication, selected partners **Robert Gans, Blair Nicholas, Erik Sandstedt** and **Gerald Silk** as four of the 500 "freshest faces in American law." To have four partners from a firm this size selected to such an elite list is a tremendous achievement. Congratulations to our Lawdragons!

Visit www.blbglaw.com to read more about Mr. Gans, Mr. Nicholas, Mr. Sandstedt and Mr. Silk and their selection to "*Lawdragon* New Stars, New Worlds" or go to www.lawdragon.com.

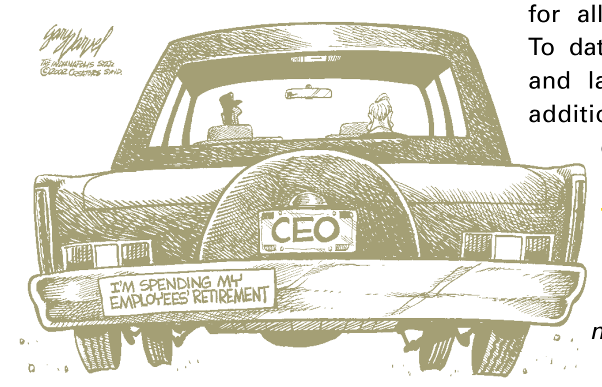
MIRROR, MIRROR ON THE WALL...

Continued from page 5.

"in the money" stock options with an exercise price of $50, X Corp is obligated to account for the $50 difference between the exercise price and current trading price as an expense. Thus, when a company backdates a stock option grant, it is overstating the company's earnings by understating its compensation expenses.

Backdating also overstates earnings when companies improperly take federal income tax deductions on backdated stock option grants to executives. For example, when an option is exercised, the company typically can take any gain pocketed by the employee as a deduction on its tax return, because the Internal Revenue Service views the profit as extra compensation paid to the employee. In contrast, "in the money" options to senior executives do not qualify for this deduction. To the extent a company took advantage of such deductions on backdated options, those deductions were impermissible, resulting in overstated earnings.

Finally, the SEC is investigating a related practice called "spring loading." Whereas backdating involves directly falsifying the grant dates, "spring loading" is the timing of stock option grants to coincide with the release of favorable information. For example, a company might issue stock options immediately before announcing positive news—such as a lucrative new contract or regulatory



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The SEC is also investigating a related practice called "spring loading," another form of options timing manipulation. Whereas backdating involves directly falsifying the grant dates, spring loading involves timing stock option grants to coincide with the release of favorable information.

approval of a program — knowing full well that the stock will soar on the news, thereby giving grantees an instant paper gain. Thus, spring loading involves obtaining securities while in possession of non-public information and has been compared to insider trading. Although spring loading differs from backdating, the purpose is the same: manipulating the timing of stock options to obtain stock options with unfairly low strike prices.

Debate continues, however, about the proper analysis for each of these forms of manipulation. It is unfortunate that public shareholders — the owners of the company — are once again finding that many corporate executives are more interested in feathering their own nests than building the foundation necessary for all shareholders to be rewarded. To date, a multitude of investigations and lawsuits have commenced, with additional disclosures and lawsuits occurring on an almost daily basis. Stay tuned!

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