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THE RESULTS ARE IN... CLASS ACTION SETTLEMENTS ARE SIGNIFICANTLY HIGHER WHEN INSTITUTIONAL INVESTORS ACT AS LEAD PLAINTIFFS

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

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

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Background

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

Notwithstanding Congress' efforts, the initial response of institutional investors to the PSLRA was somewhat tepid. In 1997, the SEC noted that "Congress' efforts to encourage more active participation by institutional and other large investors has not yet taken hold... in the 105 cases filed in the first year

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after passage of the PSLRA, we have found only eight cases in which institutions have moved to become lead plaintiff." Thus, in the immediate aftermath of the PSLRA's passage, it appeared that institutional investors, who had not traditionally participated in securities class action lawsuits, were still not convinced that seeking a role as lead plaintiff could impact the bottom line: recoveries to their investors.

Attitudes Begin To Change

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

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

WorldCom: A Landmark Settlement, And Not Finished Yet

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

The NYSCRF, which suffered more than $300 million in losses from its purchases of WorldCom securities, was appointed Lead Plaintiff for the consolidated WorldCom-related securities class actions pending in the Southern District of New York. At the direction of the NYSCRF, Co-Lead Counsel for the class, Bernstein Litowitz Berger & Grossmann LLP and Barrack Rodos & Bacine, undertook an exhaustive investigation into the WorldCom fraud and uncovered key facts which had not been revealed despite in-depth investigations being conducted by the New York State Attorney General's office and the SEC.

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

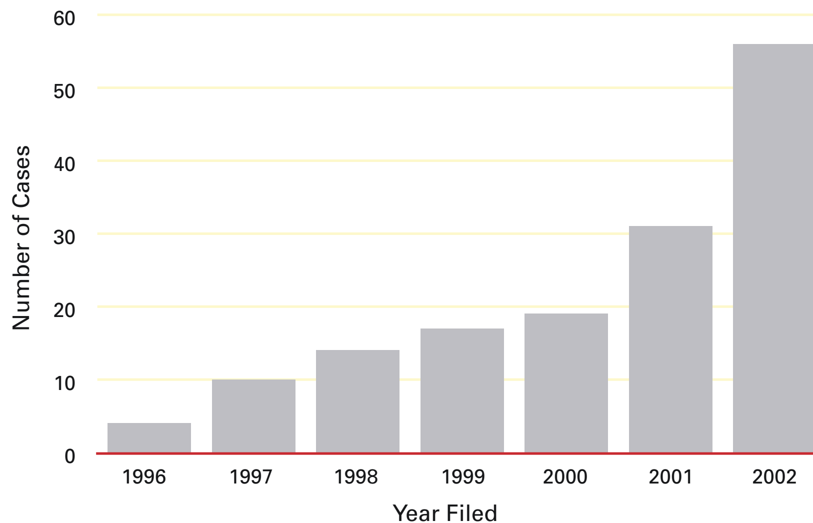
The cash payment of $2.65 billion is the second largest payment in securities class action history and, importantly, represents the largest amount — by far — ever recovered in a securities class action from a party other than the company that issued the securities. The vast majority — approximately $2.8 billion — of the *Cendant* settlement was funded by the company itself. The reaction in the investment banking community—where

"gatekeepers" such as Citigroup routinely escaped serious consequences from their lucrative relationships with fraud-ridden corporations — was one of astonishment and denial. The reaction among the investing public, however, was quite different. As a *New York Times* editorial put it: "ensuring that banks, lawyers and accountants who are implicated in corporate fraud pay heavily for their misdeeds is an important step toward restoring confidence in the integrity of the marketplace." But perhaps Comptroller Hevesi put it best when he said that defendants such as Citigroup "are the gatekeepers, they have the obligation to present the most accurate picture for investors." The partial settlement with Citigroup proves that, by taking an active role as lead plaintiff in securities class action litigations, institutional investors can help make sure that all corporate constituencies — including gatekeepers — fulfill their obligations to investors.

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

What The Research Shows

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



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

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