Investors v. Directors

By Jeffrey M. Cunningham

If corporate governance is an ecosystem, Stanley D. Bernstein, a founding partner of Bernstein Liebhard, plays a pivotal role on behalf of institutional investors who want to exert a greater influence on the interaction between boards and management. A director would argue that the threat of being named a defendant in a class action suit appears to many as overly litigious and potentially costly to the company and therefore its shareholders. The constant threat of litigation could also lead to a shift from making the right decisions on behalf of investors to making decisions that will survive a technical and legal inquiry. However, since the Reform Act of 1995, corporate governance has been in an evolving state of turmoil spurred by several well-known business failures. This has led to greater investor angst and the consequence of increased litigation aimed at directors. For the plaintiff's insight into these issues, NACD's Jeffrey M. Cunningham conducted an in-depth interview with Bernstein, one of America's leading securities and corporate governance plaintiff attorneys. Bernstein offers NACD members his candid assessment of the major issues around liability and litigation, what boards must do to limit their exposure and better perform their role with management, and the important implications of Dodd-Frank on governance.

How did you get your start in the plaintiffs' bar?

Ironically. My career started at Weil Gotshal as a securities and commercial litigation associate, representing Corporate America as plaintiffs. Fast forward, in the 1980s my wife was named "lead plaintiff" in one of the largest securities frauds involving a company named "Crazy Eddie."

That's insane.

Precisely. Now, hanging on my wall is my wife's stock certificate for 25 shares of Crazy Eddie. We had lost most of the small investment due to the famous fraud. I asked a lawyer to bring a securities-fraud class action. It ultimately settled for more than $50 million, a very large sum at the time. After it was over, I realized, "Heck, I can do this, too. And probably better." Our firm, Bernstein Liebhard, has today grown to be one of the powerhouses in securities litigation nationwide, representing large institutional holders and more than 10 states and state public pension funds in securities litigation.

Crazy Eddie stock certificate on Stanley Bernstein's office wall.

How competitive is your end of the business?

Ultra cutthroat. It has become a full-time practice just to court institutional investors. Today, if a public pension fund issues an RFP to establish a panel of securities litigation firms, they are likely to get 30 or 40 law firms responding. The Reform Act has empowered the institutional investors in their selection of counsel and in negotiating fees very aggressively, which has perhaps inured to the benefit of the classes.

What was the impact of Milberg Weiss and Bill Lerach departing the business?

Most of the name partners of Milberg left the practice but the firm is alive. Its California office split off several years ago and is quite active in its own right. The plaintiffs' bar is quite resilient. You can throw legislative, judicial and legal hurdles in the way, but there's a way to overcome them all by pleading, lobbying and replacing one talent with the next generation of talent.

So the prospects for profitable litigation are good?

Ben Franklin was wrong: death and taxes are not the only certainties. Fraud is, too. And so will be fraud litigation. But there are certain cases that are not economic to pursue because they're just so expensive to litigate. That has led to more competition on the remaining cases.

What is it about a particular case that makes it expensive?

The biggest driver right now is electronic discovery, which has transformed all types of litigation and any significant case that survives a motion to dismiss.

Presumably due to volume?

Nobody has come up with a magic bullet of how to examine 10 or 20 million documents quickly. Today, every piece of paper and electronic communication is saved. Ten years ago, documents were shredded, and not necessarily nefariously. Now, people don't write notes, they send emails, Blackberry messages, instant messages, and there is a record for all of it and it's ghastly expensive to gather and ghastly expensive to review. But in those silos are the perennial needles in the haystack. I think one of the other sea changes is that because of the recession, many large defense law firms don't have that much business, so in cases that would have been resolved earlier in the past, there may be an incentive by the defense to stretch out the eventual sit-down to resolve the matter.

How important is it to you to represent the class?

That's why we live. It is essential to our mission to protect investors.

Now, wasn't the PSLRA (Private Securities Litigation Reform Act) of 1995 intended to reduce securities litigation?

Yes, and it has invigorated it in ways that only the most prescient could have envisioned. The largest impact is the misguided belief that with the heightened pleading standard and the requirement for a "lead plaintiff," it would be more difficult, if not impossible, for institutional investors to use securities litigation as a vehicle to accomplish goals and right wrongs. But the unintended consequence is that investors actually saw this as their vehicle to show their beneficiaries that they're fighting hard to reform Corporate America, and with respect to the heightened pleading standards, it forced the plaintiffs' bar to sharpen its tools, and file better complaints. Candidly, some of those complaints prior to the Reform Act were not up to par. So, we've uncovered methods to plead cases that are far superior to anything that existed prior to 1995, through the use of investigators, the internet, whistleblowers, confidential witnesses—and, yes, the requirement to have a lead plaintiff with a significant financial interest in the outcome.

"A well thought-out, albeit wrong decision, might get you voted out of office; a hasty uninformed decision will get you sued."

What is the requirement for a lead plaintiff?

The PSLRA requires the court to appoint as lead plaintiff the person or persons with the largest financial interest, that is, loss, at stake in the litigation. Prior to the PSLRA, the lead plaintiff was generally the first person to file a complaint, no matter how small the losses were.

What do you think will be the biggest impact of Dodd-Frank on litigation and the board?

The most important part of Dodd-Frank is the one that directors and corporate boards are petrified of—whistleblower provisions.

Because there are incentives?

The incentives to whistleblowers are causing our phones to ring off the hook. We're hearing from executives and lower-level managers with a panoply of fraud allegations: financial fraud, tax fraud, federal-funding fraud. In the past, when people would come to us with these types of claims, there wasn't much we could do for them. Now it has become turbo-charged. Corporate America is petrified and claiming it is undercutting internal compliance mechanisms.

Isn't there a provision that the incentives will be higher if you went through the compliance department?

The incentives are the same, but the SEC is time-stamping the information since the bounty is paid to the first whistleblower to report the fraud.

So any federal agency could be your benefactor?

Correct. All the agencies now are equally invigorated. Because Madoff was such a black eye to Washington, his scandal subsequently led to Dodd-Frank. The credit crisis that followed was a second black eye because directors clearly did not and could not have understood the ramifications of the complex, esoteric financial instruments.

How aggressive will SEC enforcement be now that they appear to have run through their budget?

Washington has its causes du jour. So, after Madoff, SEC enforcement was the cause. But now it doesn't have enough money to set up the whistleblower office. The remedy is to simply recognize the SEC cannot do everything by itself. It doesn't have the resources. We read today that it was the New York Attorney General going after Ernst &

Young in the Lehman situation, not the SEC, not the DOJ. We have the highest respect for the SEC here, and the SEC has the highest respect for private enforcement of litigation, because they have gone on public record that this is a symbiotic relationship. The SEC's position is "private damages actions under the federal securities laws, when meritorious, serve an important role, both because such actions provide compensation for investors who have been harmed by securities laws violations and because they supplement the civil law-enforcement actions that the Commission brings."

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Let's move closer to the boardroom. What has changed in the litigation environment for directors?

Just when you think you can't find any more fraud, another tsunami unleashes itself. After Enron, nobody thought there could be anything worse. Then came WorldCom. Then the mutual fund market. Then options backdating. Now the credit crisis. The depth and breadth of possible fraudulent conduct appears to be limitless.

Is it really fair to call these "fraudulent"?

Absolutely. Corporations were cooking their books and directors were turning their eyes away.

If litigation will be a constant in business, what should directors be most concerned about?

Most officers and directors are not engaged in classic fraud, such as cooking the books. But the equilibrium needs to be on a proper decision-making process rather than just rubber-stamping management's recommendations. A well thought-out, albeit wrong decision might get you voted out of office; a hasty, uninformed decision will get you sued.

What other types of lawsuits are being filed against boards?

Directors should deeply understand that investor angst is focused on the failure to disclose the risks inherent in running your very business. For instance, BP failed to disclose issues about its oil-well safety. Nobody was cooking the books saying, "Let's hide how much oil we have in the ground," but they just as alarmingly failed to disclose issues concerning their safety and construction drilling methods. Then you have Toyota's failure to disclose and misrepresentations concerning its car design. So the thing the director has to watch out for is not just making sure your auditor is doing a good job, or that your CFO is doing his job, but finding out what the company is doing and how it is disclosing the risk. You can't just say, "The business may go bad and the economy may go sour." That type of disclosure just isn't good enough.

There's a lot of discussion that boards should be more interactive with shareholders.

This is extraordinarily meaningful: 2011 is going to be the year of power to the stockholders, a call to arms. Directors must remind themselves that they work for the company and the stockholders own the company. Directors answer to shareholders, not to management. The group that spends the most time thinking about how the board is doing are large institutional investors. They have an agenda for 2011 that will require more transparent and more balanced communications, and a policy that goes far beyond a PR or IR firm issuing press releases. It will likely involve directors and CEOs interacting directly with investors. Stockholders are not enemies and they cannot and should not be avoided.

What about boards and management interaction?

There are very good boards out there. And there are boards that are overly reliant on management, not diverse enough, not ingrained enough in the business—and they will soon be recognizing that shareholders are taking director elections very seriously. So we have proxy access, say-on-pay and majority-voting issues. We have been clamoring for an independent board chair, which I litigated for in the early 1990s at the Sears Roebuck Company, as part of several governance reforms on that board. Yet in 2010, only a minority of companies has elected an independent board chair. With a few exceptions, if you are a director of a public company today, most likely there is still a lot of work to be done.

What are the usual suspects when boards fail to meet good corporate governance standards with regard to board meeting procedures?

Challenging management's presentation seems to be the weakest aspect of board meetings. A director's job is not to nod and bless. It is to probe, challenge and guide. I urge directors to get out of the boardroom and meet senior and mid-level managers. Understand the business from the ground up. It will really help to understand the trees when you discuss the forest in the boardroom.

When you find a company practicing good governance, who most often is the primary advocate—the CEO or the board?

The best boards seem to have strong outside directors who understand and take seriously their very important role to challenge management. Most CEOs do not welcome challenge and many board members fail to understand how important it is to do just that.

What is the single most common poor governance issue on boards that you litigate against?

Deference to management.

As in?

Many directors are experts at many things. My experience is that at least in some cases, they go into a board meeting, listen to a presentation, and say, "Sounds good to me." They probe, but only to the extent that they've been trained to probe so that it looks like they probed. Directors should be counseled vigorously that they are not there to hear and bless, but to challenge and guide. My advice to board members is never to vote on anything until you can look me in the eye and explain what you did in plain English and why. It's the Warren Buffett rule: If you don't understand it, don't do it.

In what ways does the global picture increase the potential for litigation?

Many people don't realize that the international big four accounting firms are separate entities around the world. While they are supposed to have one high-quality standard, it has become apparent that the quality around the world might not meet the quality in the United States. So we had a major accounting fraud in Italy. We had a major accounting fraud in India. China has become a hotbed of litigation now.

Didn't the United States Supreme Court offer protection to foreign corporations?

Yes, to the detriment of U.S. investors. In the Morrison litigation, the Supreme Court ruled that there is no claim for a U.S. investor for securities that are purchased overseas. And that would generally be with respect to a foreign corporation. So a

Bernstein On a 'Towering' Pet Peeve

"For most directors, it is still not the practice to carefully consider the provisions of D&O policy, other than that first page. So, if you feel you'll never get sued, and all you want to do is have a big policy, that you've got x million dollars of insurance, if that gives you comfort, that's great, and your company will save some money. Individual directors should be sure that price is not the motivating factor and the face amount is not the determining factor. There are so many different insurers and so many different policies. It may only become clear that it matters who is insuring you and what those provisions are when you get the first claim filed against you. Between bankruptcy risk, disclaimer risk, fraud risk, outside counsel risk, outside director risk and just plain claims-handling procedures, the differences are enormous. Regrettably, many directors are under the impression that buying D&O insurance is tantamount to buying car insurance, where the only thing that matters is how much insurance you have. The types of litigation and issues that come up are so varied that it does require counsel or an experienced broker to guide you through the purchase of D&O insurance.

"My pet peeve is the 'tower'—often used to convince directors of ample coverage, where insureds tower themselves with five, ten layers of insurance, which is a bargain at the beginning, but is particularly costly and inefficient and ineffective at the end of the day when you or a corporate officer want to resolve the claim. Just when you are negotiating with the plaintiff, you will also now be negotiating with five or ten insurers, five or ten insurers' counsel, five or ten different insurers' claims people, not one of which is taking responsibility for the other. It seems very shortsighted to me—unless you are sure you'll never have a claim asserted."

foreign corporation has now been granted broad immunity from securities fraud litigation in the United States. Unfortunately, all that has done now is invigorated U.S. institutional investors to realize that they have to step up to the plate more often, because you can't rely on a worldwide class of investors to protect shareholder rights. Basically, the Supreme Court closed the door, so we have to open the window.

What advice do you have for directors about executive compensation?

The institutional investors are very excited about paying a fair, even a generous, compensation package to management. I haven't heard one institutional investor say, "I want a cheap CEO." What they are concerned about are irrational motivations that lead to irrational behavior, and the credit crisis is a great example. The gross amount of compensation per se is not the problem as much as the motivational tools to link to performance, recognizing that risk should not be over-emphasized in order to meet compensation goals. In the C-rooms, and quite importantly, in the trading rooms, the more common formula has been "Heads I win, tails you lose." That has got to change.

> "We have the highest respect for the SEC here, and the SEC has gone on public record that this is a symbiotic relationship."

How do you choose your litigation targets?

I can't say there's a formula, other than it is far more than a stock drop or a knee-jerk reaction. In today's environment, we have to perform a deep investigation of whether we believe that we can prove securities fraud, or a need for corporate governance reform, for two reasons: one is, we all work on a contingency. And the defense bar and the insurers do not lie down and write checks just because you sue them. More importantly, perhaps, is even if there were a plaintiff firm that wanted to bring a case on a knee-jerk reaction, a serious firm with serious institutional clients will not be able to bring that because the clients are very sophisticated. It is not their goal to sue. The goal is to not have to sue. But we monitor their portfolios and advise when we believe there is a bona fide securities-fraud case and pension-fund client boards will cross-examine us as to what we believe is the basis of a claim; it's got to be more than just they lost money.

Is venue selection important in securities class action and what role does Delaware play?

In a classic securities-fraud case, you don't have that many choices in venue selection, because the law generally says the case needs to be brought in the state of the principal place of business of the company. With respect to corporate governance litigation and derivative litigation, you do have two choices: You can go to the state of incorporation and clearly, I believe it's about 80 percent of companies are incorporated in Delaware, which has just a spectacular business court, or you can go to the state of principal place of business. And that leaves you 49 other jurisdictions with varying experience in corporate matters. Regrettably, because of the balkanization of the plaintiff's bar, you will likely be sued in both venues. And the preliminary skirmish will be over where the case should be litigated.

What about the defendant's venue issues?

They want to be in the venue that they believe will be the most favorable. But often, you just can't tell. I had a case where the defendant offered a huge procedural incentive if I would move from the state of incorporation to the business' home Court. They obviously believed that they would get a very, very fair shake being a very large company in a particular town. We accepted the offer to move and then never lost on the home front. Not surprisingly, we settled the case on very favorable terms.

How do you assess director and officer liability?

There are a host of damage calculation formulas for a classic securities-fraud case, and obviously, the plaintiff's model leads to much more aggressive damage analyses than the defendant's. They can be polar degrees apart. The way I look at it, when negotiating with defendants as to what the liability risks are, I get to the point where I go to the jury and the jury finds in my favor. Then they find that your client lied, and they find that your client had intent to lie. Now the same jury has to listen to two experts. One expert says, "Okay, he lied, he had intent to lie, but it didn't cause that much harm," whereas my expert goes up there and says, "He lied, he had intent to lie, and it caused a lot of harm." I don't need a jury consultant to tell me the odds are that that jury is going to go with the plaintiff's expert and the larger damage analysis. I think historically, in the few cases that do go to trial—most do get settled—the jury has generally accepted the plaintiff's damages experts.

You are saying that most corporate defendants settle?

Yes. Most cases obviously get settled, because intelligent lawyers on both sides evaluate the risks. It is the rare case that goes to trial, because it means something in the equilibrium is wrong: you have a particularly stubborn lawyer or client on one side or the other. But if you have intelligent people and good advocates on both sides, it should lead to a business solution.

What are the results of the securities cases that have gone to trial?

Actually, it's an absolute empirical flip of the coin. Of the cases that have been tried since the PSLRA was passed in 1995, slightly more than half have gone to the plaintiff's verdict, a good number have gone to the defendant's. I think about 28 securities class actions have gone to trial since the Reform Act: nine found in favor of defendants, seven verdicts were for plaintiffs and there was a mixed verdict in five. Now to me, a mixed verdict is for the plaintiff, so I would call those odds slightly in favor of the plaintiff.

How problematic is it when you have certain investors opting out of a class settlement?

It is becoming more and more common. It's more problematic for the defendants because they can't get global peace. There is a large and growing group of lawyers pursuing opt-out cases, and institutional investors are not hesitant, with the right case and large damages, to pursue an individual claim. The results empirically have been quite impressive. So the ability to get global peace, with passive institutional investors, has gone the way of the buggy whip.

When you consider defense counsel, what are the qualities you admire?

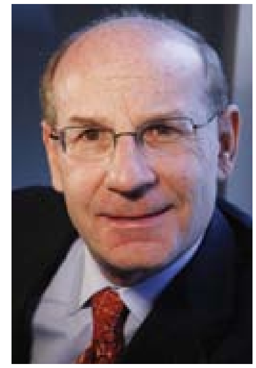
Securities litigation is really a specialized field. So the firms I want to go against are the firms that do this day in and day out on a nationwide basis. They may not be the general outside counsel. Just as there is no more than a handful of firms on the plaintiffs' side that litigate for investors' rights at a very top-notch level, there is an equally small number of firms that can size up a case and resolve it one way or another. Sometimes, when you're dealing with professionals, they will use their credibility and explain to you why you don't have a case and you may have to take great pause, when it comes from somebody you've developed respect with over 15 or 20 years.

I understand you are now representing public companies?

We have now been consulted by corporations that were defrauded. Representing defrauded corporations is not different from representing defrauded investors. We have some public corporations in our repertoire, where they themselves have been defrauded or burned by an accountant or a buyer or seller of a business or even a lawyer. And even public corporations recognize and respect that in the rare case that they must litigate as a plaintiff, it probably pays to retain a firm that specializes in plaintiff litigation. And, on a contingency basis to boot.

So in other words, you will go to heaven, Stanley.

I don't know if I'm going to heaven, but I'm at least trying to help investors pursue high-stakes litigation and maybe go to the bank along the way.



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