HALE AND DORR LLP

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Corporate and Securities Litigation Bulletin

It's Getting Expensive Out There

We were relieved to learn last month that Mr. Greenspan sees scant inflation and feels free to lop another 50 basis points off interest rates. Unhappily, from where we sit, we're seeing quite a lot of inflation. Shareholder suits are getting more expensive by the day.

To find out how expensive, we decided not to rely on anything as fragile as our impressions. We instead consulted our good friends at American International Group and National Economic Research Associates to see what those statistically-minded folks could offer us. It should come as no surprise that what they provided was extensive, illuminating and subject to varying interpretations.

A little context first. Reasonable persons can and do differ on whether the Private Securities Litigation Reform Act enacted over President Clinton's veto at the end of 1995 has to any extent discouraged shareholders from filing securities fraud claims. The number of suits per year has trended up, but so has the number of public companies. Nevertheless, if an appropriately adjusted lawsuit-per-year index were worth constructing, we are quite certain it would show that nothing about the Reform Act has been a serious disincentive to the filing of securities fraud lawsuits.

This is not to say that the Reform Act has been a bust. According to the statistics we've seen, the number of outright dismissals of shareholder suits on motion is up and sharply so. Before the Act, perhaps one case in eight was dismissed at the outset; today the ratio more nearly approximates one in four.

At least two factors yield this happy result. First, the Reform Act encouraged courts to look hard at complaints to see if real fraud – meaning some genuinely misbegotten purpose, and not a strained characterization of ineptitude or misfortune – was apparent on the face of the complaint.

Second, the Reform Act constructed a "safe harbor" within which public companies could make projections about future prospects. The logic of the "safe harbor" is that it most often is not fraud that prevents predictions from being realized and that this is particularly so when predictions are accompanied by warnings about what could go wrong. A judge who

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understands this is unlikely to be persuaded that a missed projection was fraud simply because things did not turn out as expected. As a consequence, after the Reform Act, the pure missed projections cases around the country came to be dismissed – much as they had been in New England before the Reform Act. Corporate America, especially the high technology community, briefly rejoiced.

But no law is so resilient as the law of unintended consequences. The plaintiffs' bar, deprived of one historic staple of its diet, quickly found a new and richer source of nutrition. Now, the issue is accounting – usually revenue recognition or failure to establish appropriate reserves. Although both of these theories often implicitly include an element of lack of foresight (particularly the latter), courts around the country are more prone to accept allegations of accounting irregularities as sufficient evidence of fraud. In other words, although the actual cause of share price declines prompting lawsuits is on the surface often the same (missed expectations), shareholder plaintiffs now seek with greater success to explain these circumstances as the consequence of prior accounting fraud.

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The prevalence of these cases is hard to exaggerate. Since the passage of the Reform Act there have been approximately 1100 federal securities lawsuits filed. Of these, roughly three in five contain some allegation of improper accounting.

The singular virtue of these cases, from the plaintiffs' perspective, is that they (like popular web sites) are sticky. Judges are loathe to deprive plaintiffs of the chance to prove that the numbers weren't what the numbers seemed. Once a securities fraud suit survives a motion to dismiss, it has the potential to be lucrative in the extreme for the lawyers who press it.

The explosion in accounting cases since the passage of the Reform Bill cannot entirely be explained, of course, by the need of the shareholder plaintiffs' bar for something new and improved to get past motions to dismiss. However cynical one may be, the allegations in all of these cases are not simply figments of fertile imaginations. For example, there are a significant minority of shareholder actions that follow from admitted accounting irregularities uncovered by auditors, management, or company directors. These accounting problems are real. The attention they command causes everybody with responsibility for anybody's books to grow skittish. The revenue disallowed at Company A imperils the revenue at Company B, especially when A and B share auditors. As more problems are revealed, corporate accounting entries that often are as much a product of judgment as science may more plausibly be characterized as fraud.

Part of the explanation for where we find ourselves lies within the accounting profession. Starting in 1997, for example, the auditors imposed upon themselves and their high technology clients far more stringent rules for the recognition of revenue by companies selling highly customized software. The "improved" standards to a large degree were divorced from an attempt to characterize appropriately the economics of complex software transactions, and were more tailored toward eradicating perceived abuses in the software industry identified prior to 1997. The new rigors both responded to and yielded confusion and litigation; they also engendered a broader inquiry into revenue recognition practices generally by auditors, regulators and shareholder plaintiffs.

Quite apart from rules changes, accounting firms merged – producing dislocations and instant behemoths. Inevitably, from time to time, quality control eroded a bit. More darkly, the national offices of the large accounting firms, mindful of the problems they had in the field, became ever bolder in reversing advice tendered by engagement partners to public companies who had relied on the advice. What was good revenue on Tuesday became bad revenue on Thursday because the supervisors (and the lawyers) at headquarters decided that the underlying advice which had been given for

seven quarters running, was wrong (or not so clearly correct that supervisors wanted their firm to accept the risk of allowing it to continue).

These reversals, not surprisingly, created tensions between auditors and their clients that neither necessarily proved adroit at handling: press releases announcing problems went out precipitately; the phrase "accounting irregularities" was used too casually, and cooperation between companies and their auditors vanished as the auditors hung out a shingle which said, in effect, "you can't fire us – we quit." In a little remarked upon irony, at the very moment the SEC was insisting upon auditor independence as never before (for the purpose of protecting shareholders), auditors were demonstrating that independence as never before (for the purpose of protecting themselves).

In addition, whatever the vagaries of the accounting profession, the long bull market did nothing to encourage the most conservative behavior on the part of corporate managers. The consequences of even the smallest earnings miss were visible to all and invited laceration, not just on the ticker, but on a myriad of financial news shows. The desire not to lose 40% of one's market capitalization in 15 minutes and simultaneously to earn 15 minutes of infamy on the Squawk Box apparently prompted some unfortunate decisions about what was or was not good revenue.

Finally, to give the devil its due, the plaintiffs' bar got organized – "big time" – as the Vice President would put it. The Reform Act had to some extent ended the race to the courthouse because, under that Act's provisions, the first plaintiff to file didn't necessarily get to run the show. Given more time, the plaintiffs' bar did more pre-complaint work, more digging into prior financial statements and more finding disgruntled former employees who would talk – if not for free, then for a price. The quality and detail of the initial complaints, not to mention the amended ones, improved markedly.

What followed was a kind of litigation perfect storm: more complaints from the old days (i.e. missed projections cases) would fail; fewer but better complaints – accounting claims from the new days – would prevail. The new, better cases had to compensate for the vanished older ones. Did they ever.

The average settlement of a securities fraud action in 2000 was approximately $13 million, about $4.6 million more than the average settlement in the four years preceding the Reform Act. This $13 million number is artificially depressed because it excludes some breathtaking recent settlements, including the $2.8 billion paid to settle the *Cendant* litigation. If *Cendant* is included, the average post-Reform Act settlement soars to $38.5 million.

For those who prefer medians to means (and did well enough in junior high school to remember the difference) the median post-Reform Act settlement is $5.2 million. There is, however, a wide variation around both the mean and median. In the last ten years, there have been 110 cases settled for more than ten million (about 20%), and 150 settled for less than $2 million. The remaining majority of settlements fall in the middle. It bears repeating, however, that after adjusting for *Cendant*, the average settlement in 2000 was over 50% more than the average prior to the Reform Act. If *Cendant* is included, the increase rises by an order of magnitude.

Happily, $3 billion dollar cases don't come along daily. For those of us defending these cases principally, though not exclusively in New England, the culture of the region, not to mention settled local case law, seems to weigh against such astonishing numbers. We are happy to say that none of our clients has ever paid even last year's average to settle a claim alleging accounting irregularities. Still, our puritan legacy grows ever more distant, and one of these days there will assuredly be a revenue recognition case in the neighborhood with some appalling amount being tendered in settlement.

Which invites the question: how much insurance is enough? Here there is vehement debate. We know chief executive officers who

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want not a penny of coverage on the grounds that the mere existence of insurance invites litigation. We also know directors who believe that no coverage is enough and no premium too high.

We join neither camp. On the one hand, nobody gets sued just because they have insurance (and nobody isn't sued because they don't). On the other, companies with $100 million dollar market capitalizations don't need $100 million dollars of protection. While there are no right answers, some are more plausible than others and the best programs are always company-specific based on highly individuated criteria. Given what's going on, the application of these criteria and the purchasing of appropriate coverage probably can't begin soon enough for most public companies. And these companies shouldn't expect to find that coverage at bargain basement prices. Those days are gone forever. They went out with the missed projections cases.

– *Jeffrey B. Rudman*
– *William H. Paine*

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