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Barrack, Rodos & Bacine

District Court Upholds Class Complaint Against DaimlerChrysler

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Shareholders of DaimlerChrysler AG recently received the green light from the United States District Court for the District of Delaware to pursue their claims against the company for securities fraud related to the 1998 merger of Daimler-Benz AG ("Daimler") and Chrysler Corporation ("Chrysler"). During the negotiations leading up to the merger, Daimler had assured Chrysler management that the merger would be a "merger of equals" with each company comprising 50% of the new corporate structure. Daimler's plans, however, were quite different. Chrysler's position in the new company diminished to the point where Chrysler became a mere stand-alone operating division, rather than a full-fledged "equal" partner in the enterprise, even while the new company denied that this was taking place. As we reported in our Spring 2001 Barrack Bulletin, Daimler Chrysler's CEO, Jürgen Schrempp, later admitted that this had been Daimler's plans for Chrysler from the beginning:

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Reform Of The "Reformed"

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It comes as no surprise to the plaintiffs' bar that many of the same people who are now professing moral outrage over the \$80 billion-plus loss to Enron's investors actually helped create the legal climate that allowed Enron and Arthur Andersen to think they had a license to steal.

In 1995, over the objections of the SEC and President Clinton, a group of lawmakers, lobbyists and lawyers successfully pushed for the legislation that became the Private Securities Litigation Reform Act of 1995, or PSLRA, that shielded companies and their accountants from shareholder lawsuits. Those supporters, including current SEC Chairman, Harvey L. Pitt, who was then a top lawyer for the accounting industry, and Connecticut Senator Christopher Dodd, a key sponsor of the bill, justified their support of the PSLRA as a way to eliminate abusive and frivolous lawsuits. Investor advocates, however, warned Congress that the measure went too far. It is now clear that the investor advocates were right.

Passage of the PSLRA fostered precisely the type of corporate misconduct that the wide-ranging fraud at Enron epitomizes. Congress must now address these abuses of the public securities markets in positive, uncompromising terms. Unless we are willing to permit Enron-style corporate greed to become the norm, the PSLRA must change to make the securities laws tougher on corporate misconduct.

So what exactly is wrong with the PSLRA? Plenty. For example:

First, while the Act was described by its proponents as a means to get rid of "frivolous litigation," in fact, it set nearly insurmountable obstacles to pursuing legitimate claims for securities fraud.

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The PSLRA requires that an injured investor alleging securities fraud “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” Although courts have disagreed on the precise “state of mind” that the Act requires -- whether recklessness, a heightened form of recklessness, or intentional fraud -- they have universally rejected the previously accepted showing of motive and opportunity alone to plead that “state of mind.” But, if a fraud is well concealed within a corporate entity, what other “facts giving rise to a strong inference” of fraud or recklessness would be available to an outsider (especially at the beginning of a case)?

Professor Hillary Sale, of the University of Iowa College of Law, has commented that federal courts have too readily accepted the provisions of the PSLRA as a license to dismiss even meritorious securities fraud cases, which are seen as both complex and time-consuming. Professor Sale and others point to the Ninth Circuit Court of Appeals decision in *In re Silicon Graphics Inc. Securities Litigation*, 183 F.3d 970 (9th Cir. 1997), as the epitome of this judicial attitude. In *Silicon Graphics*, the Ninth Circuit affirmed the dismissal of a case involving clear allegations that company insiders were aware of significant adverse factors that made their public statements highly misleading, and that those insiders sold millions of dollars of stock before a steep drop in the company’s stock price. The Court established an almost insurmountable pleading burden, requiring plaintiffs to state “in great detail, facts that constitute circumstantial evidence of deliberately reckless or conscious misconduct,” over and above the highly suspicious stock sales that left insiders millions richer and the investing public suffering from massive losses on their Silicon Graphics investments.

Second, the Act created a so-called “Safe Harbor” that exempts forward-looking projections by corporate executives from potential liability so long as the projections are accompanied by meaningful cautionary warnings of factors that could cause the actual results to differ from the projections. While the investing public clearly would benefit from corporate executives’ insights about their company’s future, as Carl McCall, the Comptroller of the State of New York (and a Lead Plaintiff in the *Cendant* case) recently commented to the New York Stock Exchange, “too often these projections -- based on scant evidence -- have been

utilized to spark the price of the company’s stock upward, only to be brought lower when the positive forecasts were not met.”

Unfortunately, in many of these situations, corporate insiders routinely dump millions (and sometimes even billions) of dollars of their personally-owned company stock when the stock is trading at its peak, while outside investors, public pension funds and even company employees with their pensions invested in their company’s stock, have suffered massive losses when the truth about the companies was revealed. The examples are alarming:

- ❖ **Enron insiders sold over \$1 billion worth of their personally-owned stock** before the company reported massive overstatements in its financial statements dating back to 1997, and the stock plunged to unheard of depths.
- ❖ **Larry Ellison, CEO of Oracle, sold over 29 million shares of his Oracle stock for a gain of \$900 million** between January 23 to 31, 2001, his first sales in 5 years, which occurred just weeks before his company announced on March 1, 2001 that it had “missed” its earnings projections and scaled back its growth forecasts.
- ❖ **Cisco insiders sold \$605 million of their Cisco stock** before that stock collapsed from \$82 to \$10 per share, and the company reported a loss for the year of \$1 billion.
- ❖ **JDS Uniphase insiders and controlling shareholders sold \$1.9 billion** before the fall of that company’s stock.

An article in *The New York Times*, “Tell the Good News. Then Cash In,” published April 7, 2002, identified the same pattern at **Global Crossing, Sun Microsystems, Vitesse Semiconductor, Guess, Xerox, Dollar General, and Provident Financial**. These are not isolated incidents, and are “hardly limited to failed companies.” The article continued:

[T]he practice appears to have gone hand in hand with the general decline in accounting standards among American companies as they strove in recent years to present their financial results in the best possible light. The recent recession and the fallout from Enron’s collapse have forced many to

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restate profits or to make more conservative forecasts, but the reckoning has often occurred after company officials walked away with millions of dollars.

In fact, stock option grants have become so large over the last decade that executives have become wealthy by selling just a fraction of their holdings during a stock-price run-up that turns out to be fleeting.

Third, the Act eliminated joint and several liability, except for “knowing” securities fraud. The Big 5 accounting firms in particular have utilized this provision to argue -- especially in cases of widespread corporate misconduct when there were “red flags” throughout the company’s financial records -- that the outside accountants, who were not managing the company, certainly could not be found liable for more than a minor percentage of the damages suffered by investors. This is particularly devastating when the principal corporate defendant disappears behind the veil of a bankruptcy proceeding. The Enron disaster is a prime example of this problem.

Fourth, in a provision virtually unknown in the rest of civil litigation, the PSLRA prevents any discovery -- the court-supervised investigation by the parties into the parties’ allegations -- in a securities case until the court decides any motion to dismiss the complaint, even if some of the defendants have



Leonard Barrack

answered the complaint and responded to plaintiff’s allegations. This provision has effectively insulated companies and their executives from defending actions for a year or more in most cases. During the discovery stay, investors are unable to prosecute their claims, and risk finding themselves at the “end of the line” when corporations melt down. For instance, in the McKesson HBOC litigation, even though the company has admitted that it included false financial statements in the proxy/prospectus for the merger of McKesson and HBOC, discovery in the case has been stayed *for over two years*, while the court has decided motions to dismiss. In the meantime, the

Enron debacle has hit HBOC’s outside auditor -- Arthur Andersen -- and the chances that McKesson HBOC investors will be able to recover anything meaningful from Arthur Andersen, which certified HBOC’s false financial statements, may be slim.

As harmful as the PSLRA has been to American investors and public pension funds, the PSLRA is not the only factor that has encouraged the massive dishonesty that appears rampant within too many corporate executive suites and boardrooms these days. Two decisions from the United States Supreme Court in the early 1990s set the stage for the unrestrained frauds surfacing now.

In 1994, the U.S. Supreme Court issued a decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), reversing consistent rulings in each of the federal circuits and eliminating aider and abettor liability for persons and entities that themselves did not make false and misleading statements, but who assisted those who did. For instance, outside accounting firms that reviewed and approved, but did not issue public opinion letters on, a company’s false or misleading quarterly financial statements could no longer be liable for such statements, even if they were aware that the statements were false. An outside law firm aware of misstatements in a prospectus for a public offering, but which did not itself sign the prospectus, was also off the hook. So, too, were outside investment advisors and even Board members who themselves did not issue statements of a company.

When consumer and investor advocates sought to reverse the Supreme Court’s ruling through legislation, the same coalition of lawmakers and lobbyists responsible for passage of the PSLRA blocked corrective legislation. Joel Seligman, an expert on federal securities law, has stated that the *Central Bank* decision, in conjunction with the PSLRA, has had a particularly profound impact on claims against accounting firms:

Together, what they did for the accounting profession is lower the probability of discovery, raise the probability of not being named a defendant, and increase the probability of the case being dismissed on a pretrial motion.

An earlier Supreme Court decision, *Lampf, Pleva, Lipkind, Prupis & Petigrew v. Gilbertson*, 501 U.S. 350 (1991), limited the time for bringing securities fraud cases to one year from the date when an investor was or should

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have been on notice of a potential claim or three years from the date of the fraudulent activity. This decision was a disaster for investors in two important respects. **First**, even when a fraud is uncovered, only investors who purchased securities within the last three years of the fraud are able to bring securities law claims; earlier victims of the fraud are left out. **Second**, courts have ruled that the one-year “notice” provision bars an investor from bringing a claim if that investor should have become suspicious about a corporate action, but did not bring suit within a one-year period after such “notice” was in the public domain. Of course, such a rule is entirely inconsistent with the PSLRA’s pleading requirement that a viable claim must be based on specific facts leading to a strong inference that a fraud has been committed, since requiring claims to be brought on the basis of “notice” may, in essence, require them to be brought before enough is known to sustain a claim.

There were also serious efforts in Congress to overturn by legislation the impact of the *Lampf* decision. Once again, the same coalition later responsible for passage of the PSLRA effectively stopped passage of the proposed *Lampf* remedial bill.

Richard Walker, the former Chief of Enforcement at the SEC, has stated that the current increase in financial fraud is at least “partially attributable to court rulings limiting corporate liability for financial fraud and the Private Securities Reform Act of 1995, which removed joint-and-several liability except when there is a knowing violation of law.” With such restrictions on the ability of investors to go after companies, Mr. Walker noted, “there is an increase in these kinds of frauds.”

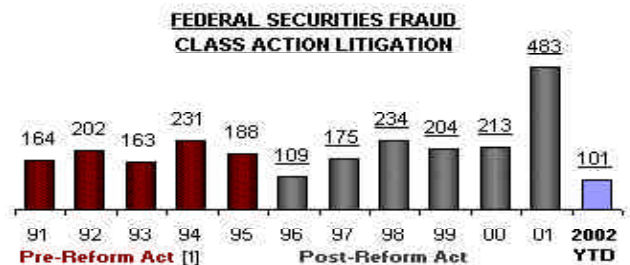
Clearly, this is no time for rolling back laws meant to protect public investors. To the contrary, the laws and regulations that apply to accounting firms, issuers of public securities, corporate boards, audit committees, investment banks, corporate law firms and financial advisors, should be strengthened. The past six and one-half years have seen a rash of corporate misconduct at companies throughout the economy -- from Wall Street firms to Silicon Valley companies, at manufacturing stalwarts, at energy companies, and at cable and telecommunications companies. It is no coincidence that this level of accounting fraud and corporate misconduct, often accompanied by enormous insider

selling of stock acquired largely through stock options, has taken place on the heels of the enactment of the PSLRA and Congress’ failure to override the Supreme Court decisions in *Central Bank* and *Lampf*. Support for legislation to correct the egregious errors in the PSLRA and to counter the *Central Bank* and *Lampf* decisions should be top priority, or investors will be saddled with the “reforms” that brought us Cendant, Enron and their ilk. ❖

What Good Was The PSLRA?

The ostensible purpose of the PSLRA was to eliminate so-called abusive and frivolous lawsuits. But did it? According to the Securities Class Action Clearinghouse at Stanford Law School, certain patterns in securities litigation have emerged in the five years since the passage of the PSLRA:

❖ The number of companies sued has not changed dramatically. The chart below depicts a relatively consistent number of cases filed during the 1990s, showing only a small dip in 1996, immediately after passage of the PSLRA and a spike in 2001, related to the proliferation of cases filed against brokerage firms alleging improprieties in the distribution of IPO shares:



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❖ According to an October 26, 2000, article entitled “Securities Reform: What Went Wrong?” in the New York Law Journal, the percentage of cases being dismissed jumped from 13% before the PSLRA to about 30% in the years since its enactment.

❖ A larger percentage of litigation has centered on accounting fraud, especially revenue recognition issues.

❖ Allegations of insider trading have increased.

❖ The dollar magnitude of settlements has skyrocketed. Five post-PSLRA cases settled for more than \$200 million, including the over \$3 billion settlement in the Cendant lawsuit.

So what effect did the PSLRA have? These statistics suggest that some in corporate America looked at the PSLRA as a license to steal. ❖

Accounting Fraud: What Are They Talking About?

Edward M. Gergosian, Esquire
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With the discovery of the massive accounting fraud at Enron Corporation and the company's subsequent bankruptcy, along with the revelations of questionable accounting practices at many other corporations, investors have been left wondering how this could have happened.

The threat to our capital markets is a familiar one; man's ingenuity to commit financial fraud knows no bounds. From the South Sea Company Bubble in the 18th century to Ivan Boesky, Michael Milken and Charles Keating in the 1980's, investors have been repeatedly rocked by one fraudulent scheme after another. And financial fraud is as prevalent as ever. Since the 1929 stock market crash, the federal government has enacted legislation designed to protect the integrity of the markets, and to permit investors to seek redress for losses caused by the fraud. However, in the wake of the passage of the Private Securities Litigation Reform Act of 1995 ("PSLRA") and before the Enron revelations, investors witnessed the revelation of financial fraud at Cendant, Informix, McKesson, Waste Management, Sunbeam, Legato, Xerox, Microstrategy and Critical Path. The post-Enron implosion includes Global Crossing, Tyco, Qwest Communications, Homestore.com, Adelphia, and Dynegy.

What is the impetus for management to engage in these clearly improper transactions? The answer is simple. Money.

But what exactly did these companies do? In this and subsequent articles, we will discuss exactly what makes up a "financial fraud."

Special Purpose Entities

The spectacular collapse of Enron was the result of the company's abuse of and misrepresentations about special-purpose entities or "SPEs." SPEs can be legitimate vehicles for corporate financing and tax benefits. A corporation can also use SPEs to remove risk from the balance sheet. To utilize an SPE for legitimate purposes -- and account for an SPE as an independent entity -- a corporation must satisfy two requirements: 1) someone independent of the company must make an equity investment of at

least 3% in the SPE; and 2) that independent investor must control the SPE. If these criteria are met, the SPE is considered an independent entity and any debt incurred by the SPE is kept off the company's balance sheet. For Enron, an energy-trading company, the SPEs were critical to maintaining its credit rating. Over time, however, personal incentives prevailed as Enron executives headed and partly owned some of the SPEs, generating substantial outside income for those executives. Once the independence of an SPE is compromised, the legitimate use for the entity evaporates, causing a negative impact on the company's financial statements.

There were hundreds, and perhaps even thousands, of these SPEs at Enron. The SPEs were used to artificially inflate Enron's reported revenues, while disguising Enron's liabilities and related party transactions. In some, Enron placed failing, troubled assets to hide losses. Other SPEs employed complex financial transactions to create enormous revenues and earnings for Enron. The SPEs were set up to benefit Enron executives, and provided minimal tangible business benefit to the company. The SPEs -- which the market knew little if anything about -- hid hundreds of millions of dollars of losses and debt from the public. Enron has now restated billions of dollars previously reported as earnings from SPEs, or previously hidden losses in SPEs. The SPEs also were the vehicle by which Enron executives caused Enron to report approximately \$1 billion in net income that was eventually reversed in 2002. Enron's demise was triggered by disclosures about three such SPEs that were run and partly owned by Enron executives, including Enron's former CFO who made more than \$30 million from just two of the SPEs.

Enron's Board of Directors -- including the members of its Audit Committee -- approved these executive-run partnerships, and claimed it did so for reasons of expediency. Because Enron executives would operate the partnerships, quicker decisions could be made about



Edward M. Gergosian

whether to take part in a particular transaction, which the Board rationalized would benefit both the company and the partnerships. To deal with the obvious conflicts, safeguards required that Enron's officers and directors review and approve deals between Enron and the partnerships. But it is

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clear that Enron's Board of Directors, Audit Committee and auditors, Arthur Andersen, tolerated self-dealing by the company's own executives, and failed to require timely and accurate public disclosure about the SPEs.

When the market started focusing on the SPEs in October 2001, it learned of the multitude of problems facing Enron that were buried in its complex partnerships. From the ensuing disclosures, investor confidence in Enron collapsed. By December the company was forced to file for bankruptcy-court protection. The damages from this fraud have run into the billions, harming both open market purchasers and tens of thousands of Enron employees who had invested for their retirement in Enron stock. The senior officers and directors of Enron fared far better, having sold over \$1 billion of their own Enron stock before disclosure of the truth about the company's fraudulent financial reports.

Other companies have also been caught misusing SPEs. The SEC is investigating Adelphia Communications Inc. and \$2.7 billion in off-balance-sheet debt tied to closely held partnerships; AOL Time Warner Inc., which owns the nation's second-largest cable company, recently revealed that it has \$2 billion of off-balance-sheet debt tied to an SPE; Cablevision Systems Corp. disclosed in an SEC filing that it has \$939 million in "off-balance-sheet commitments and contingencies."

"Capacity swaps" have had little business purpose beyond boosting financial "results."

Retailers also commonly use SPEs to securitize accounts receivable for inventory purchases or to finance store growth and other operations. For example, Circuit City Stores Inc. recently revealed a \$3 billion, off-balance-sheet securitization program for its credit-cards and car loans from its CarMax affiliate. Krispy Kreme Doughnuts Inc. and Dollar General Corp., have recently come under scrutiny for their use of so-called synthetic leases, under which the company uses an SPE to acquire real estate or equipment without putting the debt on its balance sheet, while at the same time enjoying the tax benefits of owning the property. Krispy Kreme has since announced it will no longer use synthetic leases, and Dollar General recently

restated earnings in the wake of controversy over its synthetic leases.

Capacity Swaps

"Capacity swaps" or "wash trades" occur where one company sells and then buys back the same amount of product. These swaps give companies the opportunity to record revenue from the swaps in the quarter they are made while deferring the expense of buying product over a number of years. According to several sources in the telecommunications industry, many "capacity" swaps have had little business purpose beyond boosting financial "results."

The Securities and Exchange Commission and the Federal Bureau of Investigation are probing whether Global Crossing Ltd. falsely inflated revenues by booking hundreds of millions of dollars in "hollow" swaps of capacity it might not have needed. From acquisitions and large initial contracts with other telecom carriers, Global Crossing's revenues soared to \$3.79 billion by 2000 from \$419.9 million in 1998. But as the company completed its 100,000-mile fiber-optic network in the spring of 2001, it was clear that network capacity was overbuilt and builders were vastly overextended. Prices for fiber capacity fell by 50% every six months, and the first wave of bankruptcies hit the sector. Global Crossing, however, continued to promise investors continued and dramatic revenue growth.

Former Global Crossing senior executives now allege that with telecom carriers cutting back on capacity purchases, company employees began to feel pressure to put any kind of deal together in the first quarter of 2001. As a result, the company began turning more aggressively to swap transactions. In particular, former Global Crossing senior executives have revealed one \$150 million exchange transaction with 360Networks, for North American and Atlantic routes on which Global Crossing already had substantial capacity. In another first-quarter 2001 swap, Global Crossing "sold" Qwest capacity worth \$100 million, and then Global Crossing "roundtripped" the cash by purchasing \$100 million of capacity from Qwest.

The market reacted favorably after the company issued its first-quarter 2001 financial results, and commended Global Crossing's performance in such a tough environment. But by the second quarter of 2001, cash business with other telecoms was drying up. Former Global Crossing employees say the frenzy of reciprocal transactions

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Theragenics Class Decision: An Important Victory For Class Representatives

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Barrack, Rodos & Bacine and their co-counsel recently obtained a decision from the United States District Court for the Northern District of Georgia certifying the *Theragenics Securities Litigation* as a class action. The decision by Judge Thomas W. Thrash, Jr. is a ground-breaking interpretation of the standards for class certification under Rule 23 of the Federal Rules of Civil Procedure and has favorable implications for the future of class action litigation of securities fraud claims.

Background. Securities fraud cases are complex and costly to litigate. To make it economically feasible for counsel to devote sufficient time and resources to litigate securities fraud cases on a contingent fee basis, the amount at stake must be high enough that a successful recovery will adequately compensate counsel for their time and effort, while allowing an adequate recovery for the class. Bringing securities fraud cases as class actions enables plaintiffs to aggregate the losses of all investors similarly situated and to conduct the litigation on behalf of all of them, not just those who filed the suit.

For a case to proceed as a class action, the court must formally declare, or certify, the case to be a class action. If the court declines to certify the case, the only persons who will recover if the litigation is successful are the plaintiffs who actually filed the lawsuit. Because of the economic implications of this issue, class certification is a critical phase of litigating securities fraud claims.

The basic standards for class certification are set forth in Rule 23 of the Federal Rules of Civil Procedure. Included among these standards are requirements relating to the nature of the claims being litigated, for example, that the claims of all class members share common issues of law or fact; requirements relating to the class itself, for example, that it be sufficiently large to make individual suits impracticable; and requirements relating to the adequacy of the persons being put forward to represent the class to fulfill that role.



M. Richard Komins

The courts have consistently interpreted these standards over the years, and until recently most class action lawyers believed that the standards were reasonably clear. The adequacy requirement was not considered to be difficult to satisfy. The courts have long recognized that in complex cases like securities litigation, which often involve difficult financial, accounting or technical knowledge as well as sophisticated legal issues, lawyers who specialize in such litigation play an important role in making strategic decisions. Federal courts almost uniformly have held that the adequacy requirement was satisfied if the class representatives retained competent, experienced counsel, had no obvious conflict of interest that would keep them from zealously representing the interests of all class members, and were genuinely committed to prosecuting the case.

All of that was cast into doubt in July 2001, however, when the United States Court of Appeals for the Fifth Circuit issued an opinion in *Berger v. Compaq Computer Corp.*, 257 F.3d 475, 483 (5th Cir. 2001), which reversed an order of the district court certifying a class of purchasers of the stock of Compaq Computer Corp. Although the decision was based on a technical error made by the district court, the court appears to hold that the Private Securities Litigation Reform Act of 1995 (the "PSLRA") required the courts to apply a new, higher standard in evaluating the adequacy of the class representatives.

The Theragenics decision adds clarity to an area of the law that had been unfortunately muddied in recent months, and that is of great importance to defrauded investors, both large and small.

The *Compaq* decision sent shock waves through the securities bar. Defendants in securities class actions immediately began to argue that for class representatives to satisfy the adequacy standard, they must now have detailed knowledge about the factual and legal issues in the litigation as required by the *Compaq* decision, a view that, for the most part, had been consistently rejected by the courts for many years. Plaintiffs' lawyers feared that an unintended consequence of Congress' stated goal, in enacting the PSLRA -- to place more control of class action litigation in the hands of institutional investors and others with large stakes in the outcome of the litigation -- was to make it virtually impossible to find *any* class representative who could satisfy such a heightened adequacy standard.

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Cross Pens Caught In The Cross Fire

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Since the passage of the Private Securities Litigation Reform Act of 1995, federal courts across the country have wrestled with the Act's pleading requirements for securities class action fraud claims. In a recent decision, the United States Court of Appeals for the First Circuit, (with jurisdiction over Massachusetts, Maine, New Hampshire, Rhode Island and Puerto Rico), appears to have changed course and adopted a more realistic pleading standard for these claims.

The First Circuit's decision in *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72 (1st Cir. 2002), involved a case brought by purchasers of stock in A.T. Cross Corp., the maker of Cross pens. The case centered on the consequences of the company's mid-1990's decision to counter its lagging sales by entering the personal electronic devices market by offering pen-based computing products. Cross had high hopes for its new product line, but reality did not keep pace with the company's projections. In an April 22, 1999, press release, Cross announced that the company's sales had dropped dramatically and the news caused Cross' stock price to plunge below \$4 per share. By late 1999, Cross had discontinued the new product line and suffered losses that essentially eliminated the profits Cross earned on these products in 1998.

The First Circuit, in a significant departure from previous holdings, appears to have adopted a more realistic and, ultimately more attainable, pleading standard for securities fraud cases.

The investor suit on behalf of purchasers of Cross common stock that followed accused Cross of failing to disclose its use of contingent sales strategies and of inaccurately reporting those sales on the company's financial statements. United States District Court District Judge Mary M. Lisi of the District of Rhode Island dismissed the suit, finding that the investors had neither provided sufficient factual support for the allegations of fraud nor raised a strong inference of "scienter," the defendants' knowing or reckless indifference to the facts. The investors appealed Judge Lisi's decision to the First Circuit Court of Appeals.

The First Circuit reversed Judge Lisi's decision. The ruling is significant for a number of reasons. The First

Circuit Court of Appeals, which traditionally has required great specificity to support fraud claims, here found that the plaintiff adequately pleaded his claim that Cross made strongly optimistic statements about its new product line but failed to disclose several accounting and sales practices that hid the product's poor performance in the market. On behalf of the three-judge panel that decided the appeal, Judge Sandra L. Lynch, wrote:

Although the pleading requirements under the PSLRA are strict ... they do not change the standard of review for a motion to dismiss. Even under the PSLRA, the district court, on a motion to dismiss, must draw all reasonable inferences from the particular allegations in the plaintiff's favor, while at the same time requiring the plaintiff to show a strong inference of scienter.

284 F.3d at 78.

Judge Lynch found that the district court had erred when it concluded that even if Cross made false statements or material omissions, there was no evidence that the Company knew the statements or omissions were misleading at the time they were made. Instead, Judge Lynch found that if the plaintiffs can prove their claims they can show fraud. Thus, it was "an extremely reasonable inference, from the defendants' statements in 1999, that the Company had offered its customers price protection guarantees in 1998, likely to induce them to carry the new... product lines," but had done so without disclosing such guarantees to the investing public. This, according to the Court, made it reasonable to infer the Company's earlier public statements "were misleading and that the defendants knew that they were misleading."

This was a significant departure from the strict pleading standard previously adopted by the court in *Greebel v. FTP Software, Inc.*, 194 F.3d 185 (1st Cir. 1999), a favorite case among corporations accused of securities fraud. The *Greebel* opinion, also written by Judge Lynch, required a fact intensive level of pleading that was a boon to defendants seeking to avoid liability for fraud. This new opinion will take the bite out of the *Greebel* decision.

The *Aldridge* court also held that the plaintiff had met the pleading standard for scienter even though Cross never restated any of its financials or otherwise indicated any error in its 1998 financial statements. The court refused to require plaintiffs in shareholders' suits to submit proof of financial restatement in order to prove revenue inflation:

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Cross Pens

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[T]he fact that the financial statements for the year in question were not restated does not end [plaintiff's] case when he has otherwise met the pleading requirements of the PSLRA. To hold otherwise would shift to accountants the responsibility that belongs to the courts. It would also allow officers and directors of corporations to exercise an unwarranted degree of control over whether they are sued, because they must agree to a restatement of the financial statements.

284 F.3d at 83. As the Court stated, "while inferences of scienter must be reasonable and strong, they need not be irrefutable." 284 F.3d at 82.

Indeed, citing a decision of the Eighth Circuit Court of Appeals that Barrack, Rodos & Bacine recently obtained on behalf of investors in a class action against the Green Tree Financial Corp., (*see below*), the Court wrote: "the

fact that the defendants published statements when they knew facts suggesting the statements were inaccurate or misleadingly incomplete is classic evidence of scienter." 284 F.3d at 83. The Court also found additional support for the scienter allegations in plaintiff's allegations that the corporate officers had particular financial incentives to commit fraud, included allegations that (a) Cross management's compensation depended on the Company's earnings, and (b) the same management who had set specific target sales goals would have found their jobs in jeopardy if the goals were not met. 284 F.3d at 83-4. The Court concluded that: "[w]hile this case does not involve trading while in possession of material nonpublic information, which in some circumstances may be taken to support allegations of motive, there were sufficient other sources of financial motive that make the absence of such evidence less important here." 284 F.3d at 84.

Thus, the First Circuit, in a significant departure from its previous holdings, appears to have adopted a more realistic and, ultimately more attainable, pleading standard for securities fraud cases. Defrauded investors will clearly benefit from this new approach. ❖

Green Tree Blunts Reach of PSLRA

Robert A. Hoffman, Esquire
Barrack, Rodos & Bacine

The *Aldridge* decision is one of several recent decisions by the circuit courts of appeals that have viewed the pleading requirements of the PSLRA with a measure of practicality and realism. Another such decision is *In re Green Tree Financial Corp. Stock Litig.*, 270 F. 3d 645 (8th Cir. 2001), in which Barrack, Rodos & Bacine, acting as co-lead counsel on behalf of purchasers of Green Tree common stock over the 2 ½ year period from July 1995 through January 1998, obtained a reversal of a decision of the federal district court in Minnesota dismissing the action.

Green Tree (acquired by Consec, Inc. in 1998) was a "sub-prime" lender that originated mortgages for mobile homes. It securitized pools of these loans and then used so-called "gain on sale" accounting to immediately recognize the revenue that was expected to be generated over the future life of the loans. The extent of revenue that Green Tree was able to recog-



Robert A. Hoffman

nize through this technique was highly dependent on a number of assumptions, the most important of which concerned the rate at which borrowers were prepaying their loans. In January 1998, Green Tree announced that it was taking \$390 million in write-downs and restating its financial results for 1996 due to higher than expected prepayment rates. Citing specific statistics in their complaint, plaintiffs allege that Green Tree's financial statements were based on prepayment assumptions that defendants knew were unreasonably low. The district court granted defendants' motion to dismiss, finding that the complaint failed to satisfy the heightened pleading standards of the PSLRA.

The reversal of this decision by the Eighth Circuit Court of Appeals is significant for at least two reasons. First, defendants had argued that prepayment rates are only one of several variables that determine the extent of revenue that can be recognized under gain on sale accounting and that plaintiffs had failed to allege that these other variables did not act to offset plaintiffs' allegations concerning unreasonably low prepayment rates. The Eight Circuit flatly rejected this argument:

Undoubtedly, the accounting issues are complex; whether they were handled within the parameters of good faith decision-making or whether the decisions amounted to recklessness

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If I had gone and said Chrysler would be a division, everybody on their side would have said, “There is no way we’ll do a deal.” But it’s precisely what I wanted to do.

The institutions comprising the Lead Plaintiff group in this case are Denver Employees Retirement Plan, Policemen’s Annuity and Benefit Fund of Chicago, Municipal Employees Annuity and Benefit Fund of Chicago and the Florida State Board of Administration. Barrack, Rodos & Bacine and co-counsel had filed a detailed First Amended Consolidated Class Action Complaint on April 9, 2001, alleging violations of Sections 11, 12(a)(2) and 15 of the Securities Act of 1933, for misstatements in, *inter alia*, the Proxy and Prospectus issued in conjunction with the Merger, and violations of Sections 10(b) and 14(a) of the Securities Exchange Act of 1934 for misstatements relating to the company’s sales practices. Defendants moved to dismiss this Complaint, along with the complaints filed by certain individual plaintiffs.

The ruling upholding the Second Amended Complaint is an important first step toward the goal of obtaining a significant recovery on behalf of the Class.

The Court issued its initial ruling on the motions to dismiss on March 22, 2002. In its opinion, the Court upheld the substance of the “merger-of-equals” claims in all the complaints, ruling in favor of the plaintiffs on all of the key issues. The Court rejected each of the arguments defendants made, finding, *inter alia*, that:

- ❖ The allegations regarding defendants’ statements about the supposed “merger-of-equals” between Daimler-Benz and Chrysler were sufficient to base a claim for securities fraud;
- ❖ Plaintiffs adequately alleged the necessary elements of their claims relating to the Proxy and Prospectus, including reliance, causation and damages;
- ❖ Plaintiffs satisfied the strict pleading requirements of the Private Securities Litigation Reform Act;
- ❖ The complaints adequately alleged claims against the DaimlerChrysler’s CEO and CFO relating to the Proxy and Prospectus; and

- ❖ The cautionary language in the Proxy and Prospectus did not preclude plaintiffs’ claims.

The Court, however, found that plaintiffs’ claims relating to the company’s sales practices in late 1999 through the first half of 2000 were not actionable under the securities laws, and dismissed those claims on their merits. The Court also found, with respect to all claims in the complaint, that the Lead Plaintiffs had not sufficiently “linked” the sources of their information with the allegations of misconduct derived from those sources. As a result of this perceived pleading deficiency, the Court granted defendants’ motions to dismiss the Class Complaint, but allowed plaintiffs to re-plead the Proxy and Prospectus claims.

Because Barrack, Rodos & Bacine and co-counsel believed that the dismissal of the Proxy and Prospectus claims was inconsistent with the law in this area, we filed a motion for reconsideration of the Court’s ruling or, in the alternative, for leave to file a Second Amended Complaint that resolved the perceived problems with the allegations the Court had identified. The defendants opposed the motion, arguing that our changes to the Complaint would not cure the pleading deficiencies. Plaintiffs quickly responded by filing a reply brief in further support of their motion.



Jeffrey W. Golan

the original Complaint.

On May 8, 2002, less than two weeks after plaintiffs’ counsel filed the reply brief, the Court granted the motion for leave to file an amended complaint, and ruled that Lead Plaintiffs were entitled to file the proposed Second Amended Complaint. The Court allowed the Second Amended Complaint because it directly addressed the Court’s concerns about the pleading of sources for the fact allegations in

With this decision, the Lead Plaintiffs, on behalf of themselves and the Class, may prosecute their claims based on defendants’ misstatements related to the merger, in tandem with the two individual cases that the Court consolidated with the class case. The ruling upholding the Second Amended Complaint is an important first step toward the goal of obtaining a significant recovery on behalf of the Class. Please feel free to contact us should you have any questions about the Court’s ruling, or any other aspects of the case. ❖

Green Tree

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will surely be the focus of any trial of this case. We will not prejudge that issue. But neither the district court, nor we, can conduct a battle of experts on a motion to dismiss. Rather, we must assume the truth of the allegations pleaded with particularity in the complaint. The strong inference pleading standard [of the PSLRA] does not license us to resolve disputed facts at this stage of the case.

270 F. 3d at 666. The *Green Tree* decision strongly admonishes the lower courts that the heightened pleading standard of the PSLRA are not intended to raise the bar so high as to require plaintiffs to effectively prove their case at the outset of the litigation.

The *Green Tree* decision is also important because, like the *Aldridge* case in the First Circuit, it acknowledges that executive compensation can be a significant factor in assessing whether defendants had a motive to commit fraud. These decisions stand in contrast to a number of lower court decisions that minimized the role of executive compensation. In *Green Tree*, the Company's Chairman and CEO, Lawrence Coss, had, in the words of the Eighth Circuit, a "remarkable contract" awarding him 2.5% of *Green Tree's pre-tax* income, making him one of the most highly paid executives in the country. His contract, however, was due to expire at the end of 1996. The Eighth Circuit found that Coss's compensation was highly relevant to his motive to commit fraud, holding:

We conclude that the magnitude of Coss's compensation package, together with the timing coincidence of an overstatement of earnings at just the right time to benefit Coss, provides an unusual, heightened showing of motive to commit fraud.

270 F. 3d at 661. Nor was the Eighth Circuit persuaded by Coss' argument that his motive was negated by the fact that his bonus compensation was in the form of stock and there were no allegations that he engaged in any insider stock sales. The Court observed that Coss's receipt of the stock could have been the first step in his plan to benefit from manipulating *Green Tree's* earnings and "[w]e may not dismiss the investors' complaint merely because the alleged plan did not come to fruition." 270 F.3d at 663. ❖

Theragenics Class Victory

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The state of the law was further clouded in January 2002 by another decision in the *Compaq* case. The plaintiffs in that case asked the Fifth Circuit to rehear the appeal. Even though the court declined to do so, it issued a short opinion clarifying that — contrary to certain explicit language in its previous opinion — it had not intended to rule that the PSLRA had changed the adequacy requirement in securities fraud cases. While it reaffirmed its prior ruling, it said that the ruling was in fact based on pre-PSLRA precedents.

The Theragenics Ruling. Between the time of the first *Compaq* decision by the Fifth Circuit and its decision denying rehearing, the plaintiffs in the *Theragenics* case filed a motion to have that case certified as a class action on behalf of all investors who purchased *Theragenics* stock during the period from January 29, 1998 to January 11, 1999. Even though the Northern District of Georgia, where the *Theragenics* case is pending, is in a different judicial circuit than the *Compaq* case and circuit court decisions are not binding on courts in other circuits, the defendants contested the motion on the basis of the *Compaq* decision, arguing that the proposed class representatives, who were all small private investors, were not sufficiently knowledgeable or sophisticated to represent the class. Defendants contended, in effect, that allowing the class to be represented by unsophisticated representatives would somehow be more harmful to the interests of the class than if no class at all were certified.

On March 27, 2002, Judge Thrash squarely rejected defendants' arguments and granted class certification, noting that the Fifth Circuit's January 2002 ruling on the *Compaq* petition for rehearing, clarified that it had not intended to imply that the PSLRA changed the Rule 23 adequacy standard. He analyzed the PSLRA and its legislative history and found that nothing either required or permitted modification of existing adequacy standards. Judge Thrash applied the adequacy standards that had been applied in earlier Eleventh Circuit decisions and found that the individual class representatives easily satisfied them.

This decision adds clarity to an area of the law that had been unfortunately muddled in recent months, and that is of great importance to defrauded investors, both large and small. Barrack, Rodos & Bacine is proud to have been a part of ongoing effort to provide justice and fair compensation to victims of securities fraud. ❖

What Are They Talking About?

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reached its peak inside Global Crossing and elsewhere in the industry. In second quarter of 2001, transactions linked to swaps accounted for nearly 20% of what the company called "cash revenue." By one former executive's count, 13 of the 18 largest "roundtrip" transactions occurred on the last two days of the quarter, "with the parties exchanging identical or substantially similar amounts of cash." Not surprisingly, in the post-Enron era, the revelations about these "swap" transactions precipitated the bankruptcy of Global Crossing. As with Enron, Global Crossing officers and directors sold \$1.5 billion before the disclosures of the truth about Global's financial performance.

Global Crossing was not alone in using swaps to bolster revenues. Qwest and 360Networks have been implicated in the Global Crossing investigation; Level 3 Communications has recently disclosed some capacity swaps -- seven in fiscal 2001. Energy companies have also used swaps to improperly bolster revenues, as shown by the recent revelations about "wash trades" by Dynegy, Inc., CMS Energy Corp. and Reliance Resources, Inc.

Barter Transactions

Like the SPEs at Enron, barter transactions, where one company trades goods for goods or services from another company, are not necessarily improper, but there are strict accounting principles that require them to be disclosed separately in a company's financial statements. As *Reuters* has reported, barter deals, in which no cash actually changes hands, were one of the "early tricks used by young dot-com companies to inflate revenues, but the practice was exposed years ago and was not believed to be widespread today."

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Homestore.com, an online marketer of home and real estate-related information, products and services, apparently had not abandoned the practice. The Company operates in two principal business segments: subscriptions, which accounted for approximately 66% of the Company's

reported historic revenues; and advertising, which accounted for the remaining 34% of Homestore's reported revenue. While billing itself as within "an elite group of Internet companies that have achieved cash profitability," in fact, as early as May 2000, Homestore was materially overstating revenues, both from subscriptions and advertising, and understating reported net losses. During 2000 and the first three quarters of 2001, the Company overstated revenue by more than \$190 million. As Homestore was issuing positive financial results, its insiders, who were responsible for the Company's operations and public reporting, were selling \$60 million of their own stock. The Company's overstated revenues arose primarily from the reporting of revenue from barter transactions in which Homestore traded advertising space for goods and services from other companies.

Why Does This Happen?

What is the impetus for management to engage in these clearly improper transactions? The answer is simple. Money. For most executives, a substantial portion of their compensation is provided in the form of stock options. In order for an officer to realize significant return from those options (thereby enhancing the compensation he receives), the market price of the company's stock must rise from the exercise price, which is generally the market price when the options are awarded to the executive.

In our next article on accounting fraud, we will examine the slippery slope that leads management to engage in financial fraud. ❖

About the Publisher...

Barrack, Rodos & Bacine is a boutique law firm that has been extensively involved in class and derivative actions alleging violations of securities laws for more than twenty-five years. The firm, with attorneys in offices located in Philadelphia, San Diego, New York, and New Jersey, has been appointed by federal judges throughout the country as lead counsel in over 30 cases since the passage of the PSLRA and represents a number of institutional investors in securities class actions. The *Barrack Bulletin*, edited by Leslie Bornstein Molder, Esquire, is published four times a year.

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