KRANENBURG

No. 1 Poultry, First Floor
London EC2R 8JR
+44 20 3174 0365
kranenburgesq.com

Remarks of Werner R. Kranenburg^, Attorney & Counselor-at-Law

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Legal Risk in Investment Decisions

"Promoting the integrity of global Capital Markets Policy with focus on corporate governance, market structure, systemic risk, and regulation of the investment profession" is one of the CFA Institute's priorities. The aim of my talk tonight is twofold: to discuss legal risk and its importance in investment analysis within the context of corporate governance, and the legal tools analysts and investors have to bring about improvements in corporate governance.

I would like to thank the CFA Society of the UK and Dimitrios Tsaousis for inviting me to speak, the BPP Business School for hosting us this evening and of course all of you in attendance. For those of us on Twitter, the suggested hashtag for this event is #cfalegalrisk and I can be contacted there via @kranenburgesq. I will speak for about twenty minutes, then my colleague Anthony [Maton of Hausfeld & Co LLP] will also speak for about twenty minutes after which we're happy to take your questions. I will focus on the legal risk in relation to securities laws, Anthony will speak about legal risk in relation to competition laws.

A few weeks ago, on 29 October, the Financial Times reported under the headline *Bank gloom casts shadow over Europe*: "Banks were hit in London and across Europe after gloomy earnings and litigation charges knocked sentiment in the sector and capped overall gains on the region's equity indices." Finma, the Swiss financial regulator, ordered UBS "to increase the amount of capital it holds by 50% to deal with future litigation and compliance risks" and Deutsche Bank "put another €1.2bn aside to cover litigation, double the level expected by analysts and bringing its total expected legal costs to €4.1bn." On Lloyds Banking Group's announcement that morning of an additional charge for legacy PPI business in the quarter in the amount of £750 million, its share price declined by 2.1 percent despite "significant

^Mr Kranenburg is a New York attorney and qualified arbitrator and the principal of Kranenburg. The focus of his practice is on the representation of private and institutional investors in litigation and arbitration. Kranenburg is a City of London-based law firm concentrated on securities, investment and corporate litigation and arbitration in all courts in New York State and US federal courts, and before specialised tribunals including FINRA's.

progress in delivering [its] strategy [and] in strengthening [its] capital position."

In the US too, the following day Bank of America was reported to have "nearly doubled to more than $5bn estimates of possible maximum litigation costs [in relation to] potential penalties over allegations of mis-selling mortgage securities."

As of mid-October, "JPMorgan ha[d] spent $8 billion on litigation and set aside $20 billion toward legal and regulatory costs since January 2010." The more recent tentative settlement agreement between JPMorgan and the US government with the headline figure of $13 billion, which includes $4 billion to end a lawsuit by the Federal Housing Finance Agency over securities disclosures, may adjust those numbers. These examples happen to be all banks but of course, legal costs and litigation are not exclusive to the financial sector.

At the end of last month, cosmetics company Avon Products announced that it remained in discussions with the US Department of Justice and Securities and Exchange Commission in relation to the investigations since 2008 over possibly bribery. Any settlements were likely to include penalties that "could, depending on the amounts of the settlements, materially adversely impact [its] liquidity, financial condition and ongoing business." Avon's share price went down by almost a quarter in heavy trading -- that is, down by $2 billion in market cap -- by mid-morning following that statement and hasn't recovered since.

Legal costs matter. Litigation matters. Litigation affects analysts and I will tell you how.

There are two important types of American legal proceedings I am going to discuss specifically, namely the derivative action and the securities class action. Both are brought by securities holders but the first is brought *against* the corporation, the second is brought *on behalf of* the corporation. I'll explain these two types of cases, give you some statistics to give an idea of frequencies and values, and a number of examples of resolved cases before my closing. I will focus on US laws and markets, on public rather than private companies, and on civil actions, not criminal prosecutions, brought by securities holders and not by regulators and government prosecutors.

In the US, a derivative action -- which is not to be confused with litigation relating to derivatives, the financial instruments -- is an action brought by one or more shareholders of a corporation or members of an unincorporated association against the corporation's directors and officers and, as nominal defendant, the corporation itself on behalf of the corporation. The plaintiff seeks to "enforce a right that the corporation or association may properly assert but has failed to enforce" or to hold directors accountable to the corporation. In doing so, the plaintiff must "fairly and adequately represent the interests of shareholders or members who are similarly situated in enforcing the right of the corporation or association."

As you may be aware, the American legal system is a federal system wherein each state has its own laws in addition to the higher federal laws that apply in all states. Derivative actions may be brought in state and federal courts under state and federal laws and rules. In the State of New York, for example, an action may be brought under the New York Business Corporation Law, Section 626: Shareholders' Derivative Action Brought in the Right of the Corporation to Procure a Judgment in Its Favor. In federal court, civil procedural Rule 23.1 applies. In legal terminology, the 'plaintiff' sues a 'defendant' by filing a 'complaint' with a court.

Under these rules generally, the shareholder-plaintiff commencing the derivative action must allege, among other things, that it is a current shareholder and was a shareholder at the time of the relevant transaction or occurrence. It must adequately represent the interests of shareholders who are similarly situated in enforcing the right of the corporation but the shareholder's own citizenship or location *don't* matter and the rules are silent on whether for example it must be a private or institutional shareholder or how many shares it should own, just that it presently owns them and has held them for the requisite period.

In its complaint the plaintiff must state with particularity "any effort by the plaintiff to obtain the desired action from the directors" and, if no effort has been made, "the reasons for not obtaining the action or not making the effort." In practice, demands are made on the board to act on the corporation's behalf or it is pleaded that such demand would be futile, that the members of the board will not sue themselves.

The primary aim of the derivative action is not a monetary settlement for the plaintiff itself or all shareholders, though it can be part of a resolution, but implementation of or amendments to the company’s corporate governance principles and practices. Corporate directors have a fiduciary duty of loyalty and care to the shareholders of the corporation. Typical allegations therefore are that present and former directors and officers breached their fiduciary duties which the action seeks to remedy.

In what is commonly referred to as 'deal cases' or 'M&A-related litigation', shareholders also bring an action on behalf of all shareholders and against a corporation's management but on the basis of allegations of breaches of their fiduciary duties or other violations of law arising out of the circumstances of a sale of the company. If the sales process is unfair or the sale for an unfair price, shareholders have the legal means to act and get involved. Remedies sought and obtained in these actions include a lowering of break-up fees, more disclosures, extensions to bid periods to allow alternative bidders to emerge, the halting of mergers and higher consideration paid to shareholders.

Securities fraud class actions are different. The two are similar in that they are brought

by a shareholder or in the case of the latter, by a holder of shares or other securities such as bonds, and that the plaintiff or plaintiffs represent the interests of all who are similarly situated, that is, the 'class'. As the New York Times said in March in an editorial under the headline *A Class Action in the Public Interest*: "Class actions are important in combating securities fraud because they permit a group of plaintiffs to pursue a legal action collectively when they may not have the resources or incentive to do so individually."

The main differences however include who the defendants in a securities class action are and where the money goes. In a securities class action the corporation is the defendant and others like investment banks and auditors may be co-defendants. Though corporate governance is a consideration, monetary compensation is the main goal and any monies awarded in a judgment or settled for between the parties go to the plaintiffs who led the action and the class they represented. Three important statutes to note are the Securities Act of 1933, the Securities Exchange Act of 1934, in particular sections 10(b) and 20(a) and SEC Rule 10b-5 thereunder, and the Private Securities Litigation Reform Act of 1995.

The word *fraud* may conjure up images of a Bernard Madoff and boiler rooms bilking ordinary investors out of billions in hard-earned savings but, in the context of securities litigation, allegations of fraud usually practically translate into allegations such as of the failure to disclose or of misrepresentation. In this context, the alleged fraud may be a company's misrepresentation of its financial strength, operations, and prospects in regulatory filings which damaged securities holders when the truth of the company's financial position came out. In such instance it may then be appropriate for one or more plaintiffs to file a complaint on behalf of the collective seeking as redress the amount of those damages.

How often do these cases happen and what are they worth? What are they worth to you? The likes of NERA Economic Consulting, PwC's Securities Litigation practice and others produce periodic research reports, which, using their own methodologies, report on filings, decisions and settlements of derivative and securities class actions and analyse trends such as by industry, type of claim and other characteristics like in which court the cases were filed.

I'm going to go through some numbers now, briefly, on filings, settlements and their values, so bear with me but one number to bear in mind which I will refer to later as six hundred. In December last year, NERA expected the number of securities class actions commenced and not yet resolved to increase to 596 by that year's end.

In its semi-annual study published in January and covering last year, NERA reported that filings of securities class actions only slightly declined in 2012, with a total of 207 class actions filed in federal courts last year, compared to the average rate of 221 over the previous five years. The number of cases relating to the credit-crisis was down which to some extent

was offset by filings of what NERA calls 'merger objection' cases, which accounted for 25% of new filings in 2012. In all, 152 cases were dismissed or settled in 2012, compared to the 244 securities class actions resolved in 2011. For the 93 cases that were actually settled in 2012, settlement values were near their average level of recent years, up from the relatively low level of 2011.

On settlement values, PwC, in its study under the heading "2012: less crisis, more crossroads", notes that "[a]long with the decrease in the number of settlements in 2012, the total value of settlements also posted a dramatic 32% decline to $2.3 billion, compared to $3.4 billion in 2011", though that figure does exclude one 'outlier' settlement of $2.425 billion. The average settlement value last year, also excluding the outlier as well as a few undisclosed and so-called zero-dollar settlements, was approximately $38 million and the median settlement value was just over $9 million.

To give you three noteworthy examples of shareholder litigation in the last few years: News Corporation[1], Kinder Morgan[2] and Grupo Mexico[3].

You may be following the news of the current trial of the two former News of the World editors and News Corporation executives over allegations of phone-hacking. The derivative case brought by shareholders, which plaintiffs described as "the culmination of over a decade of bad faith disregard by the News Corp Board of Directors of its fiduciary duties" and in which phone-hacking featured as well, has already been resolved. In June, the Court approved a settlement that will see News Corp recover $139 million for itself, funded by insurance covering the News Corp board, and implement "additional meaningful" corporate governance and compliance measures.

After Kinder Morgan announced it was to acquire El Paso Corporation it emerged that Goldman Sachs was on both sides of the transaction. On the sell-side, Goldman Sachs acted as a financial advisor to El Paso on matters related to the transaction. On the buy-side, Goldman Sachs owned 19% of Kinder Morgan common shares and had two representatives on Kinder Morgan's board of directors, the board which approved the transaction. Shareholders filed suit alleging the transaction was "unfair both with respect to process and price and is designed to benefit El Paso's and [Kinder Morgan's] insiders to the detriment of [shareholders]. The Proposed Transaction is rife with conflict..." The litigation resulted in a court-approved settlement last year with Kinder Morgan paying $110 million to El Paso shareholders and Goldman Sachs agreeing to forgo its $20 million fee in the transaction. The Court said that "[t]his should not have gone down how it did" and following this outcome, Goldman Sachs

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1 *In re News Corporation Shareholder Litigation*, Consol. C.A. No. 6285-VCN, Delaware Chancery Court
2 *In re El Paso Corp. Shareholder Litigation*, Consol. C.A. No. 6949-CS, Delaware Chancery Court
3 *In re Southern Peru Copper Corporation Shareholder Derivative Litigation*, C.A. No. 961-CS, Delaware Chancery Court

announced it was to review its conflict-of-interest policies and procedures for investment bankers.

In a deal valued over $3 billion, New York Stock Exchange-listed Southern Peru, or Southern Peru Copper Corporation as it was known then, acquired Minera Mexico, another Mexican mining company, from Grupo Mexico, the controlling shareholder of both Southern Peru and Minera Mexico. Southern Copper shareholders sued Grupo Mexico and challenged the transaction as unfair. Following trial, the Court agreed it was a "manifestly unfair transaction" and amounted to "commercial charity". The Court determined that Grupo Mexico and its affiliate directors had breached their fiduciary duties of loyalty, holding it was a "focused, aggressive controller [which had] extracted a deal that was far better than market" and so ordered record damages in such action in the amount of $1.263 billion, the difference between the price actually paid and what would have been a fair price.

Litigation matters. Litigation affects you. It's up to you which role you play.

At a minimum, *anyone* active in capital markets will be involved in one case or another passively at some point. With two hundred new cases filed each year and six hundred cases pending at a moment in time, the more issuers you cover and the more securities you invest in, the more *inevitable* it is you will have covered an issuer subject to securities litigation and that you as investor have been part of a securities class action as a represented member of the class. Be aware of these cases and include them in your analysis, looking back and looking forward. Take note of settlements that include agreements on changes to corporate governance for re-evaluation and where settlements include a monetary recovery for investors, ensure receiving your share of that settlement fund.

Or, in addition, play an active role as well. There are no monetary settlements or awards without there being a case commenced first. A board held to account, a transaction's terms amended, changes made to how a company is run for the better, takes one plaintiff filing first. You may have a fiduciary duty yourself, to your investors. Litigation is not be taken lightly and I am not asking you to chase any meritless, frivolous claim. To the contrary. I am impressing on you that in the right circumstances litigation is one more avenue to play your part in the governance of the corporations you have a stake in.

Imagine that at some point, you *lead* one of six hundred. For yourself, for your clients, your fellow analysts. For the company, for its investors and the market.

With that I thank you for listening and give the floor to Anthony.

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KRANENBURG

Werner R. Kranenburg
Attorney & Counselor-at-Law
Principal, Kranenburg

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#cfalegalrisk
@kranenburgesq

KRANENBURG

020 3174 0365

werner@kranenburgesq.com

kranenburgesq

@kranenburgesq