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# Impact of the Corporate Scandals On New York State

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August 2003

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New York State  
Office of the State Comptroller  
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## Executive Summary

The string of corporate scandals emerging over the past two years has had a tremendous impact on the holdings of individual and institutional investors. Unlike past scandals that were associated with specific sectors of Wall Street, today's scandals have involved most facets of business, from individual businesses and companies and their corporate officers to the accounting industry and investment banking houses. Despite their broad scope, the scandals did not have an immediate impact on the market as a whole. However, consumer confidence and faith in Wall Street sharply declined as the number of companies restating their financial statements increased, investigations and indictments were announced, and smaller investors began feeling the impact in their individual financial statements. From mid-March 2002, when the scope of the scandals widened, to mid-July 2002, the Standard and Poor's 500 stock index declined by almost 28 percent.

The nationwide economic impact of the scandals was significant. According to the Brookings Institution, response to the scandals reduced the national economy by \$35 billion in the first year after they were revealed. The rapid decline of the stock market also harmed state and local economies. The New York State economy lost \$2.9 billion because of the scandals during this same period. As the stock market fell in response to the scandals, New York State tax revenues decreased by \$1 billion in State fiscal year 2002-03, primarily from a reduction in personal income tax receipts due to lower capital gains realizations. The reduced economic activity also contributed to revenue losses for local governments across the State. For example, we estimate that the scandals contributed a \$260 million loss to New York City.

The revenue losses experienced by the State were not the only fiscal impact. The New York State Common Retirement Fund declined because of the drop in the stock market. From 2000 to 2003 the fund dropped from a high of \$127 billion to \$96 billion. This drop placed further burdens on the State and its localities, as they are required to absorb significant increases in their annual pension contributions because such contributions are inversely calibrated to investment performance.

During the State fiscal year (SFY) ending March 31, 2003, the Common Retirement Fund lost \$15 billion in value from its equity portfolio. Using the methodology in the Brookings Institution paper, we estimate about \$9 billion of the Common Retirement Fund's overall equity losses in the last fiscal year are directly attributable to the corporate accounting scandals.

The combined impact of the recession and the corporate scandals threatened to increase State and local contributions to the Common Retirement Fund to unprecedented levels. New York State was faced with a 700 percent increase in its pension contributions in SFY 2004-03 over SFY 2003-02—amounting to an overall impact of \$1.1 billion. Some small and large counties were faced with increases of

over 1,100 percent. Some small cities faced pension contribution increases of over 3,700 percent. These spiraling contributions were mitigated by pension reform legislation passed during the Spring 2003 legislative session, but the impacts to state and local governments remain a problem.

The problem is not limited to New York State. California, Illinois, West Virginia, and Wisconsin are all considering or have already implemented plans to bond out their increased pension liabilities. We estimate that the scandals contributed almost \$7 billion in losses to the New York City pension system.

Since March 2003 the market has been showing signs of improvement. These improvements are welcome. The damage to state and local budgets, however, is irretrievable. The losses to individual investors, particularly those who are 50 years and older, are unlikely to be recouped prior to their retirement.

In the wake of these scandals the New York State Common Retirement Fund and other major institutional investors have embarked on an active campaign to bring class action suits to recoup portions of investment losses. Using the federal Private Securities Litigation Reform Act of 1995, the New York State Common Retirement Fund has been lead plaintiff in six suits and is a class member in numerous other class action suits. Such litigation might recoup part of the losses, but will not make the Fund or other investors whole again.

In the Cendant/Ernst and Young suit, for example, investors were able to recoup a record \$3.2 billion in cash. However, they lost more than \$8.5 billion. The average recovery for each of the 122,000 claimants, including both institutional and private investors, was about 38 percent of their overall loss.

These class action suits are primarily geared to recovering money, but they are also attempting to achieve longer-term reform of the kind of corporate practices that led to the scandals. In the Cendant suit, the company agreed to important reforms of its governance structure. In the Columbia/HCA Healthcare Corporation case, corporate governance reforms were critical components of the settlement. Both financial penalties and reforms are important elements that will help return confidence to the investing public.

To that end, the Comptroller is also pursuing a comprehensive reform agenda to challenge corporate corruption and restore confidence in the financial markets. As the sole trustee of the NYSCRF, the Comptroller will continue to work to develop and implement stronger and more effective corporate governance structures, insure the independence of members of boards of directors, increase the transparency of audits and reports, promote shareholder resolutions and proxy voting as a means to influence management, and lobby for tougher federal regulations.

## Scope of the Corporate Scandals

Periodic corporate scandals and accusations of fraudulent accounting are not new to Wall Street, nor are the market collapses that often follow. Past collapses, however, were in large part caused by failings within specific segments of the financial sector. For example, financier Jay Gould's manipulation of the gold market and flaws in the bond and species markets caused the collapse of the market in 1869. Overspeculation of railroads caused the financial panic of 1873. The stock market collapse in 1929 highlighted failings within the nation's banking system and an overspeculation of stocks by the American public.

Unlike past scandals that involved specific sectors of Wall Street, today's scandals implicate most facets of business, from individual companies and their corporate officers to the accounting industry and investment-banking houses. The recent scandals, which have roots in accounting practices used by small companies throughout the 1980s and early 1990s, first surfaced on the New York Stock Exchange (NYSE) in the late 1990s. However, not until after the collapse of Enron in 2001 did investors begin to recognize the scope of institutional corruption in corporate America—and as a consequence, the market responded.

### 1987–1997: Presage of the Scandals

Between 1987 and 1997 the U.S. Securities and Exchange Commission (SEC) investigated over 300 publicly traded companies for fraudulent financial reporting, which was a dramatic increase over previous years and demonstrated a decline in the standards used by accounting firms, a failure to enforce some standards, and a laxity on the part of firms' auditors.<sup>1</sup> However, the investigations had almost no direct impact on Wall Street or the psyches of investors, nor did they receive wide media attention because the majority of the companies under investigation had less than \$100 million in assets and were not listed on the NYSE.<sup>2</sup>

The continuing deterioration of the application of accounting standards manifested itself in an increase in the number of earnings restatements issued in the late 1990s. Whereas only 44 corporations issued earnings restatements in 1995 and only 48 companies did so in 1996, the number nearly doubled in 1997—and by 1999, financial restatements had increased to over 200 (see Figure 1).<sup>3</sup>

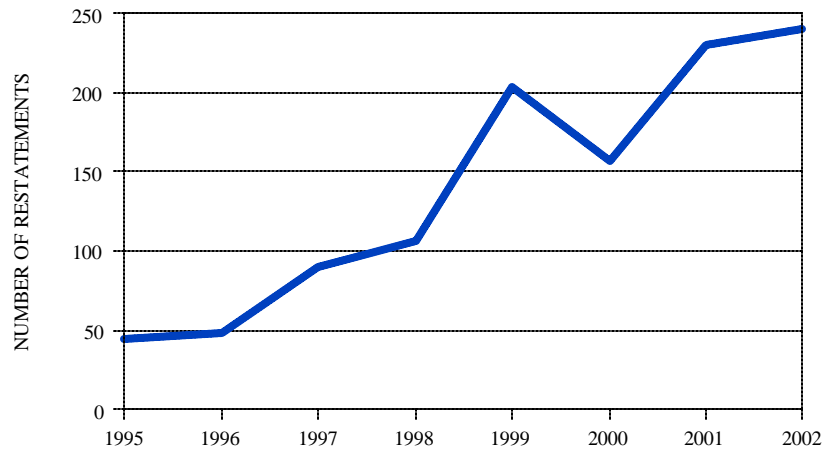
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<sup>1</sup> Hakenbrack, Kevin. *Fraudulent Financial Reporting: 1987–1997—An Analysis of U.S. Public Companies*. Committee of Sponsoring Organizations of the Treadway Commission (COSO) Web site: <<http://www.coso.org/>>.

<sup>2</sup> Although the median assets of the companies investigated were only \$16 million, the median financial restatement was \$4.1 million, representing over 25 percent of assets.

<sup>3</sup> Benston, George, et al. *Following the Money: The Enron Failure and the State of Corporate Disclosures*. AEI Brookings Joint Center for Regulatory Studies. 2003.

Figure I  
**Corporate Earnings Restatements**



Source: OSDC analysis

At the same time, the share of households investing in the stock market rose from 37 percent in 1989 to more than 50 percent in 2001.<sup>4</sup> Excluding pension fund holdings, equities climbed as a percent of household assets from 11 percent in 1982 to 46 percent in 2000.<sup>5</sup> More and more people were investing their money in the stock market, tying their wealth and fiscal security to the stability of Wall Street. This, combined with the stock market boom of the 1990s, ensured that if the market were to fall, personal wealth would fall with it.

One group particularly vulnerable to the change in wealth was older Americans. The value of stock market investment rose sharply during the bull market, primarily because of their retirement investments. According to the Federal Reserve Bank's recently released Survey of Consumer Finances, the median value for both direct and indirect stock investments for a family was \$34,300 in 2001.<sup>6</sup> However, the median value was \$81,200 for families headed by those aged 55 to 64, and was \$150,000 for families headed by persons aged 65 to 74. Stock holdings as a share of a household's assets approached 60 percent for those in the 45-to-54 age group, and remained over 50 percent for households in the older age groups. Between the 1998 and 2001 surveys, the median value for stock holdings in households headed by those aged 65 and older more than doubled—the fastest rate of expansion among all age groups. By comparison, the overall median value of stock ownership rose 5.3 percent during this interval. Thus, retirees were left exposed to significant reductions in income if stock market wealth were to decline.

<sup>4</sup> Graham, Carol, et.al. *Cooking the Books: The Cost to the Economy*. Policy Brief no. 102. The Brookings Institution. August 2002.

<sup>5</sup> Ibid.

<sup>6</sup> Indirect stock holdings include those in mutual funds, retirement accounts, and other managed assets.

## **1998–2000: Scandals Surface on the NYSE**

While Enron was one of the largest and most visible companies to restate its earnings, it was not the first major corporation to do so. In April 1998, Cendant Corporation, a provider of travel, real estate, vehicle, and financial services, revealed that it had inflated its earnings by \$115 million. The next day Cendant stock dropped by 46 percent, from \$32.625 per share to \$19.06 per share. In July, Cendant issued another restatement, admitting to an additional \$400 million in inflated earnings. In a subsequent criminal action, Cendant executives and employees pleaded guilty to filing fraudulent financial reports. More importantly, they stated that they did so under the explicit orders of company executives. As investigators continued to explore the Cendant case, revelations emerged that Cendant CEO Henry Silverman and former Chairman Walter Forbes sold more than 3.8 million shares of Cendant prior to the April earnings restatement. They realized a combined profit of more than \$143 million.

On April 28, 1999, one year after Cendant revealed its restatements, McKesson HBOC admitted recording \$42 million in unpaid software contracts as revenues. McKesson stocks fell 51 percent that day, cutting the company's market value by \$9 billion. Three months later, McKesson announced an additional \$328 million in reported revenues that had yet to be collected. The SEC and the U.S. Attorney General announced that they would open investigations into McKesson's financial reporting. Criminal charges have now been filed. Despite these and prior revelations, investors' confidence remained high. However, that soon changed.

## **2001: Enron Makes History**

On October 16, 2001, Enron Corporation announced a \$35 million decrease in stated earnings and a \$1.2 billion loss of shareholder equity due to an exclusion of three partnerships from past financial statements. Compounding Enron's problems was the November announcement that an additional \$500 million in earnings were overstated. Then, on December 2, 2001, Enron filed for Chapter 11 protection, making it the largest bankruptcy in U.S. history. By using accounting tricks and imaginary profits, Enron's rise as the preeminent energy trader was based on manipulations of the market, not a successful business model.

The collapse of Enron had a ripple effect on the market. Investors initially convinced themselves that it was an isolated incident, and the belief prevailed that the market would rebound. Yet as a number of earnings restatements and accounting scandals became public, and often resulted in criminal investigations of corporate officers and their independent accounting firms, this belief changed.

## 2002–2003: A Pattern Emerges

In January 2002, Global Crossing, one of the nation's largest telecommunication companies, filed for bankruptcy because of \$48 billion in inflated earnings. Less than a week later, the SEC began investigating Global Crossing CEO Gary Winnick, who sold \$732 million of company stock prior to the earnings restatement. In March, Adelphia Communications, a leading cable television provider, revealed \$2.3 billion in off-balance sheet loans that resulted in inflated earnings. These revelations led to bankruptcy for Adelphia and the eventual arrest of former CEO John Rigas and three family members for accepting more than \$5.6 billion in illegal loans from the company.

In June, Tyco International CEO L. Dennis Kozlowski was arrested for evading \$1 million in New York sales taxes on personal purchases of artwork. After his arrest, details of Tyco's schemes to avoid taxation became public. During Kozlowski's tenure as CEO, Tyco cut its effective tax rate from 36 percent in 1996 to 23 percent in 2001, saving more than \$600 million a year.<sup>7</sup> The Manhattan District Attorney later accused Kozlowski and former Tyco CFO Mark Swartz of taking more than \$600 million from their company in a series of unrelated charges. In addition, Kozlowski forgave more than \$100 million in loans to company executives for "relocation" costs, which included luxury yachts, extravagant parties, personal artwork, and multimillion-dollar homes. These practices caused investigators to reexamine Tyco's past filings, which resulted in a negative restatement of earnings of \$382 million on September 26, 2002.

Xerox, long viewed as a stable and reliable company, also revealed \$6.4 billion in overstated earnings in June 2002. A lengthy investigation by the SEC uncovered over \$3 billion in inflated revenues and \$1.5 billion in pretax earnings. This resulted in a \$10 million fine, which was the largest ever levied by the SEC for financial reporting violations.<sup>8</sup> As Xerox and other established companies such as Bristol-Myers Squibb issued restatements, investors began to acknowledge that the increasing number of scandals was not an aberration but instead indicated a pattern of accounting irregularities. Investors also began to fear that no company was a safe investment.

Throughout the winter and spring of 2002, the media reported scandal after scandal, which kept the issue of corporate accountability in the forefront of investors' minds (see Figure 2). Then on June 25, WorldCom—the second-largest telecommunications provider in the nation—disclosed \$3.8 billion in off-balance sheet debt. This resulted in WorldCom's July 21 bankruptcy filing, which replaced Enron as the largest

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<sup>7</sup> Symonds, William B. "The Tax Games Tyco Played." *BusinessWeek*. July 1, 2002.

<sup>8</sup> Byrnes, Nanette. "Xerox Has Bigger Worries Than the SEC." *BusinessWeek*. August 12, 2002.

bankruptcy in U.S. history. By September, WorldCom restated earnings a second time, dropping estimated earnings by an additional \$5 billion.

**Figure 2**  
**New York Times Headlines: November 2001–November 2002**

November 2001	SEC Opens Investigation Into <b>Enron</b> (11/1)	Energy Giant Suddenly Flailing (11/4)	<b>Enron</b> Admits to Overstating Profits by About \$600 Million (11/9)
December 2001	With <b>Enron's</b> Fall, Many Dominoes Tremble (12/2)	<b>Enron Corporation</b> Files Largest U.S. Claim for Bankruptcy (12/3)	<b>Enron's</b> Collapse: Watching the Firms that Watch the Books (12/5)
January 2002	<b>Kmart</b> Files Bankruptcy, Largest Ever for Retailer (1/23)	Worries of More <b>Enrons</b> to Come Give Stock Prices a Pounding (1/30)	Questions on <b>Global Crossing</b> Accounting (1/31)
February 2002	SEC Scrutinizing Another Company: <b>Global Crossing</b> (2/9)	How Executives prospered While <b>Global Crossing</b> Collapsed (2/12)	<b>Enron</b> Official Says Many Knew About Shaky Company Finances (2/15)
March 2002	SEC Seeks <b>WorldCom</b> and <b>Qwest</b> Documents (3/12)	<b>Andersen</b> Charged With Obstruction in <b>Enron</b> Inquiry (3/15)	<b>Adelphia</b> May Be Liable for Millions in Loans (3/29)
April 2002	<b>Xerox</b> to Restate Results and Pay Big Fine (4/2)	SEC Accuses <b>Xerox</b> of Accounting Abuses (4/12)	Wall Street Inquiry Expanded with Subpoena to <b>Salomon</b> (4/25)
May 2002	Miscues, Missteps, and the Fall of <b>Andersen</b> (5/8)	\$100 Million Fine To <b>Merrill Lynch</b> (5/22)	<b>Deloitte</b> Is Said to Face Inquiry Over <b>Adelphia</b> (5/29)
June 2002	Ex- <b>Tyco</b> Chief Indicted in Tax Case (6/5)	<b>WorldCom</b> Said It Hid Expenses, Inflating Cash Flow \$3.8 Billion (6/26)	<b>Xerox</b> Revises Revenue Data, Tripling Errors First Reported (6/29)
July 2002	<b>WorldCom</b> Files for Bankruptcy, Largest U.S. Case (7/22)	Founder of <b>Adelphia</b> and Two Sons Arrested (7/25)	<b>Qwest</b> Announces Accounting Flaws (7/29)
August 2002	Two Ex-Officials at <b>WorldCom</b> Are Charged in Huge Fraud (8/2)	<b>WorldCom</b> Finds \$3.3 Billion More in Irregularities (8/9)	<b>AT&amp;T</b> Asked for Information on Dealings with <b>Salomon</b> (8/24)
September 2002	Two Top <b>Tyco</b> Executives Charged With \$600 Million Fraud Scheme (9/13)	<b>Qwest</b> Overstated up to \$1.48 Billion in Revenue (9/23)	<b>Salomon</b> Talks to the SEC About Settling Conflict Cases (9/28)
October 2002	New York State Says <b>Citigroup</b> Had a Conflict (10/15)	Regulators Sue <b>Deloitte &amp; Touche</b> in the Collapse of <b>Reliance Insurance</b> (10/17)	<b>Citigroup</b> Hurt By Worries That Inquiry Could Widen (10/24)
November 2002	Three Inquiries Begun into <b>SEC's</b> Choice of Audit Overseer (11/1)	<b>Adelphia</b> Sues Former Accountants, Citing Negligence (11/7)	SEC Inquiry on Homeshare Has Expanded to <b>Cendant</b> (11/25)

The effect of these scandals grew as investors read accounts of CEOs and financial officers who made millions of dollars while thousands of employees lost their jobs. In the telecommunications sector, where the market collapse cost investors a total of \$2 trillion, Qwest Communications founder Philip Anschutz made \$1.9 billion in Qwest stock sales, and former Qwest CEO Joseph Nacchio sold more than \$248 million in Qwest stock before resigning.<sup>9</sup> Global Crossing founder Gary Winnick earned \$123 million by selling Global Crossing stock before his company declared bankruptcy, and WorldCom CEO Bernard Ebbers borrowed \$400 million from his company before resigning; his loan remained unpaid when WorldCom filed for bankruptcy protection.

### **The Accounting Industry**

The corporate scandals unearthed many institutional problems within the accounting industry. In 1993, consulting fees made up 31 percent of revenues at the Big Five accounting firms (Arthur Andersen, Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers). By 1999, when the corporate scandals began to break, 51 percent of Big Five revenues came from consulting or roughly \$23 billion.<sup>10</sup> For the first time, accounting firms were earning more money from consulting than from audits, and the gap between revenues for the two services was widening. While Big Five accounting revenues were rising annually by 9 percent, revenues for consulting were increasing by over 26 percent a year.<sup>11</sup>

This growing importance of consulting within the accounting industry created conflicts of interest between auditing units and consultants. Auditors came under increasing pressure to produce audits that supported their firm's consulting advice and strategies, thus safeguarding a major funding stream for the accounting firms. This led to the collapse of Arthur Andersen, once the largest Big Five firm, and caused investors to lose faith not only in the companies in which they invested in but also in the accountants who were hired to ensure that company statements and projections were accurate.

Investors first became aware of these issues in May 2001, when Andersen settled a \$110 million suit with investors (without admitting or denying blame) over the mismanagement of Sunbeam accounts. One month later, the SEC levied a \$7 million fine against Andersen, the largest ever issued by the SEC to an accounting firm, for overstating Waste Management Inc.'s (WMI) income by more than \$1 billion over four years. In addition, Andersen accepted an antifraud injunction and a censure, again without admitting or denying responsibility, and agreed to pay part of a

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<sup>9</sup> Rosenbush, Steven. "Inside the Telecom Game." *BusinessWeek*. August 5, 2002.

<sup>10</sup> McNamee, Mike et al. "Accounting Wars." *BusinessWeek*. September 25, 2000.

<sup>11</sup> Ibid.

\$220 million class action settlement with WMI shareholders. Though these events and others like them occurred with greater frequency, investors had not yet recognized a pattern of abuse within the accounting industry. However, in October 2001, Andersen was accused of using deceptive accounting practices at Enron. In March 2002, already under suspicion from previous accounting mistakes at Sunbeam, WMI, and Enron, the SEC charged Andersen with obstruction of justice for shredding key documents relating to Enron's collapse. The public's trust in independent accounting firms fell dramatically.

In each of the cases cited, Andersen received lucrative consulting contracts from the companies it was auditing.<sup>12</sup> This created a conflict of interest for accountants who could jeopardize their firm's multimillion-dollar consulting contracts by completing an audit that was unfavorable to the client or criticized the work of the consultants. Andersen was not alone in this practice. In 2001, PricewaterhouseCoopers earned \$8.7 million from Disney for accounting work, and an additional \$43 million in consulting contracts. That same year, PricewaterhouseCoopers earned \$13 million from Tyco for accounting services, but received more than \$18 million from the company for tax advice.<sup>13</sup> Questioning Tyco's tax structure—a structure that led to the company's downfall—would have undermined the work performed by PricewaterhouseCoopers' consultants and possibly jeopardized more than half of the company's revenues from Tyco.

## **Wall Street**

As the conflict of interest between auditing and consulting services at accounting firms became public, New York State Attorney General Eliot Spitzer announced that he had reached a settlement with Merrill Lynch for producing biased analyst reports. This \$110 million settlement sparked subsequent investigations into many of the major Wall Street firms by the Attorney General's office in partnership with the SEC, NYSE, National Association of Securities Dealers, and North American Securities Administrators Association. These investigations led to a \$1.4 billion settlement between regulators and the top ten investment banks. In addition, the Wall Street firms agreed to adopt a series of regulatory reforms to combat institutional failings.

The investigations revealed that analysts based many of their recommendations not on market values or analytical research, but on the amount of money their firm stood to make in investment banking fees. In specific cases uncovered by investigators, recommendations were made to protect and give preferred ratings to banking clients, not to benefit investors. It was also revealed that investment banks paid analysts a commission of 3 percent to 7 percent for banking revenues they helped generate,

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<sup>12</sup> In the case of WMI alone, Andersen earned five times more for its consulting work than it did for its audits.

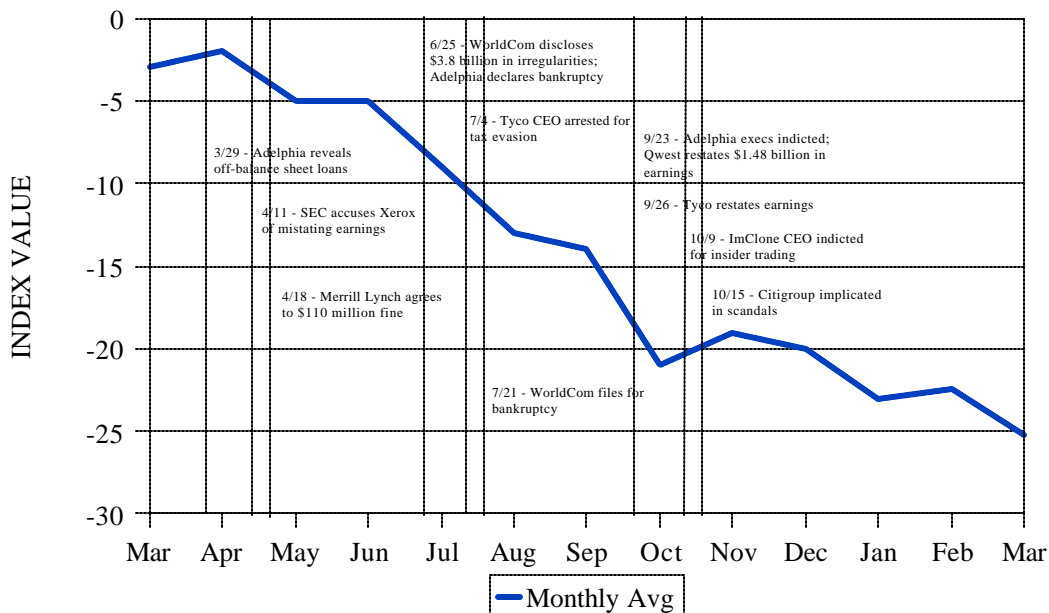
<sup>13</sup> Byrnes, Nanette. "Is the Avalanche Headed for Pricewaterhouse?" *BusinessWeek*. October 14, 2002.

which created an additional conflict of interest.<sup>14</sup> At Merrill Lynch, internal documents showed that one team of Internet analysts, headed by Henry Blodget, helped produce \$115 million in investment banking firm revenues from December 1999 to November 2000.<sup>15</sup>

Spitzer’s investigations also uncovered a practice called “spinning,” used by Wall Street firms to pursue clients. Investment banks offered their clients stocks in forthcoming initial public offerings (IPOs) at preferred prices, and clients could then sell them at a premium. This earned favored executives multimillion-dollar profits.

More than a year after the Merrill Lynch settlement was announced, allegations continue to emerge against Wall Street firms. As recently as July 2003, Spitzer filed charges against Morgan Stanley for allegedly creating improper financial incentives for its brokers to sell mutual funds that were not in their client’s best interest. Investigations into similar compensation programs at other big firms continue at the federal level and in many states; however, legislation recently considered by the House Financial Services Committee in Congress could have seriously curtailed state regulators’ ability to investigate conflicts of interest between research analysts and investment banks.

**Figure 3**  
**SFY 2002-03 Consumer Confidence Index**



Source: ABC News/Money magazine

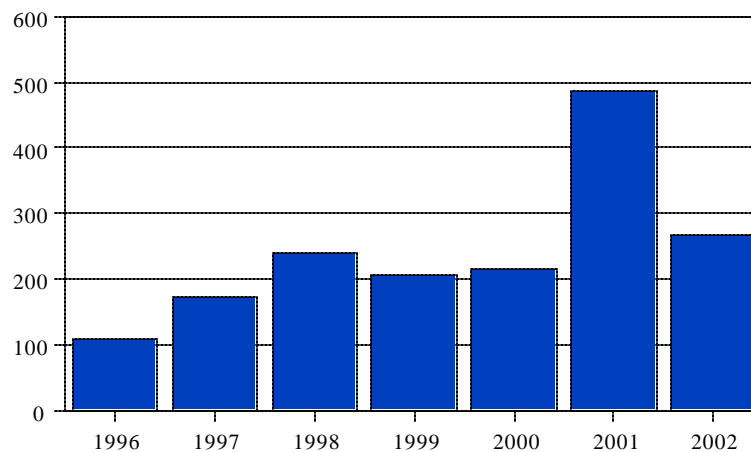
<sup>14</sup> Vickers, Marcia et al. “How Corrupt Is Wall Street?” *BusinessWeek*. May 13, 2002.

<sup>15</sup> Cassidy, John. “The Investigation: How Eliot Spitzer Humbled Wall Street.” *The New Yorker*. April 7, 2003.

## Investors Respond

As the third quarter of 2002 began, investors continued to lose faith in the companies in which they invested, the accountants who audited them, and the analysts who rated them. As the barrage of newspaper articles continued, the Consumer Confidence Index continued to decline, reaching a low of -23 in October before war jitters moved to the forefront of investors' minds (see Figure 3). The depth of the corporate scandals led *BusinessWeek*, in a cover story on May 13, 2002, to ask not if Wall Street was corrupt, but how far the corruption had spread.<sup>16</sup> This institutional corruption resulted in billions of dollars in lost capital and a deflation of the market. As investors evaluated their losses, the action moved from the boardroom to the courtroom. Investors filed over 400 class action lawsuits against companies and their accountants in 2001 in an attempt to recover some of the losses caused by the scandals (see Figure 4). In the first quarter of 2003, there were 74 class action suits filed for securities fraud, which could lead to almost 300 new cases this year.<sup>17</sup>

**Figure 4**  
**Federal Securities Fraud**  
**Class Action Litigation**



Source: Securities Class Action Clearinghouse (SCAC)

<sup>16</sup> Vickers, Marcia, et al. "How Corrupt Is Wall Street?" *BusinessWeek*. May 13, 2002.

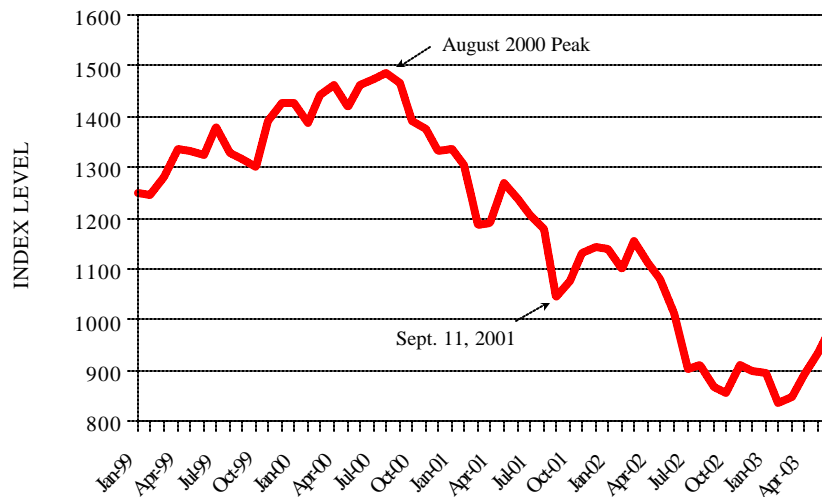
<sup>17</sup> Stanford Law School Securities Class Action Clearinghouse Web site: <<http://securities.stanford.edu/>>.



# The Cost of Corporate Corruption

After the stock market peaked in August 2000 and the technology-driven bull market ended, the financial markets started a steady decline. A short national recession began in March 2001 and ended in November 2001, with the gross domestic product declining until the fall. The market plunge deepened in the wake of the September 2001 terrorist attacks; however, a rally began in late 2001 as economic data showed that the national economy was not falling into a deeper recession. In early 2002 the economic prospects appeared to be improving, and a *USA Today* survey of investment strategists published in January of that year showed expectations of a modest market gain for the year. The markets did continue to rise until March 2002, by which point the public focused on the numerous evolving corporate scandals that then drove markets sharply lower through the summer. During this period—between mid-March and mid-July—the markets declined by almost 28 percent. Part of this decline was related to data showing that neither corporate profitability nor the overall economy was making a significant comeback. Just as markets appeared to be stabilizing at the end of 2002, they began to fall again due to concerns over a war with Iraq (see Figure 5)—which led to the third consecutive year of market declines as the Standard and Poor's 500 Stock Index fell more than 20 percent for the year. Concerns about military conflict continued to pull the market down in early 2003, although markets rallied briefly in March during the early stages of the war. As the war progressed, markets became more volatile in response to the daily reports of battlefield successes and failures. Nevertheless, by mid-April the military conflict appeared to be winding down and the financial markets had begun to advance again, although there were fluctuations due to fiscal developments, domestic economic news, and corporate profitability reports. The markets were still moving forward in mid-August 2003.

**Figure 5**  
**Standard & Poor's 500 Stock Index**



Source: Standard & Poor's

Overall, the Standard & Poor's 500 Index rose almost 384 percent, or over 1,178 points, during the bull market rise from October 1990 through August 2000. Between the market peak in August 2000 and the market low in February 2003, the index fell by almost 44 percent, or about 648 points. The decline in the index between mid-March 2002 and mid-July 2002 amounted to almost 323 points. This eliminated over one quarter of the bull market gains of the 1990s.

In general, the performance of the financial markets contributes to the wealth of individuals. Increased wealth occurs with the sale of a financial instrument and the realization of a capital gain. However, increases in the financial markets create unrealized paper wealth that makes individuals feel better off—known as the “wealth effect.” Over time, as households feel they have more money, they gradually increase their consumption to match their perceptions. Likewise, as households see their financial holdings become less valuable, they feel poorer and modify their spending behavior to deal with this contingency. Because approximately half of all households in the nation own stock, movements in the financial markets can have a major impact on actual and perceived wealth—and can significantly affect consumer spending, which represents about two thirds of the national economy.

Rising financial markets also increase the ease with which businesses can access capital and lower the cost of that capital. This in turn helps fuel growth in business investment, which is necessary for continued productivity growth and expanding the economy. Thus, both businesses and consumers benefit from rising financial markets.

### **Estimating the Economic Impact**

An article in the January 1999 Federal Reserve Bulletin, “Aggregate Disturbances, Monetary Policy, and the Macroeconomy: The FRB/U.S. Perspective,” examined the relationships utilized in the Federal Reserve's national econometric model. This model is used to simulate the economy's behavior after potential fiscal and monetary policy actions are taken to respond to different disturbances in the national economy. The relationships cover a broad range of topics and issues, including employment, earnings, prices of goods and labor, the cost of capital, rates of return on investment, consumption, behavioral adjustments, and expectations. Understanding the behavior of the financial markets is a major concern, as they affect rates of inflation, the resources available for business investment, the wealth of consumers, and their spending patterns. The relationships affecting household wealth and spending are particularly important, as consumer spending accounts for about two thirds of economic activity in the nation.

Much of the article covers examples of the model in use, such as evaluating the impact of interest rate changes, shifts in productivity, changes in the value of the dollar, increases in income, or price shocks. One of the conditions explored involves

the response to a reduction in stock market wealth. Utilizing this model, Federal Reserve economists found that a sustained 20 percent decline in stock market wealth ultimately reduces the GDP by 0.4 percent after one year, 0.8 percent after two years, 1 percent after three years, and 2.1 percent after ten years. The declines in GDP occur because of reduced consumption spending (with the reduction in personal wealth) and less investment (with rise in the cost of capital).

These relationships between stock market wealth and the economy were applied in an August 2002 policy brief by the Brookings Institution entitled *Cooking the Books: The Cost to the Economy*. As the financial markets deteriorated with continued news of corporate scandals and accounting irregularities through early 2002, the brief's authors sought to estimate how much the scandals contributed to a decline in wealth, and in turn, economic output (for a discussion of the authors' methodology, see the box on the next page). The decline caused by the scandals would be part of the much larger decline in wealth—and reduction in GDP—arising from the financial markets' decline from its 2000 peak.

Using the Federal Reserve's relationships between changes in stock market wealth and the economy, Brookings estimated that the corporate scandals would reduce the GDP by \$35 billion, or 0.34 percent, in the first year, assuming that stock markets did not deviate significantly from their levels of July 19, 2002. This base estimate assumed that about 60 percent of the 28 percent decline in the stock market between March 19, 2002 and July 19, 2002 resulted from the corporate scandals. Using their alternate lower and upper interval assumptions about the amount of the market decline attributed to the corporate scandals (30 percent and 90 percent), the Brookings authors then estimated that the range of the economic impact of scandals could vary in the first year from a lower limit of \$21 billion, or 0.2 percent of the GDP, to an upper limit of \$50 billion or 0.48 percent of the GDP (see Figure 6).

**Figure 6**  
**Impact of Accounting Scandals on the National Economy**

Case	Total Market Decline During Study Period	Weighting of March 19 to June 24 Market Decline Due to Scandals	Weighting of June 24 to Jul 19 Market Decline Due to Scandals	Overall Weighted Share of Market Decline Due to Scandals	Decline in Wealth Due to Scandals	Decline in GDP Due to Scandal-Related Wealth Decline (\$ billions, 1996 dollars)
Base	27.6%	50%	75%	60.0%	16.9%	-35.4
Low	27.6%	25%	50%	30.0%	10.0%	-21.0
High	27.6%	75%	100%	90.0%	23.8%	-49.9

Source: The Brookings Institution

## Methodology Utilized in the Brookings Study

The financial markets were expected to improve in the beginning of 2002. Although the corporate scandals had begun to break in 2001, they had yet to be considered a widespread problem in investors' minds. In addition, a rally in the markets was moving forward; however, the market's close on March 19, 2002 proved to be the peak. The Brookings Institution authors used this date as the starting point for their study period. For the end date they selected July 19, 2002—the Friday close before the weekend announcement that WorldCom was filing the largest bankruptcy in U.S. history. As the Brookings authors tried to assess the impact that the corporate scandals had on the financial markets, they viewed WorldCom's June 25, 2002 announcement of a \$3.8 billion earnings restatement as a major turning point in investor awareness. Thus, within the study period, the authors decided to give less weight to the impact of the scandals on investors before June 25, and more weight after that date.

Overall, the Standard and Poor's 500 stock index declined almost 28 percent during the period between March 19 and July 19. The decline through the June 24 close amounted to about 15 percent, and the subsequent decline from June 24 through the July 19 close also represented nearly 15 percent. In the study's base case, the Brookings authors assumed that the scandals were responsible for 50 percent of the drop in the Standard & Poor's 500 stock index between the market's close on March 19 and its close on June 24, but they then assumed that 75 percent of the drop from the June 24 close through July 19 was scandal-derived. This yields a weighted net assumption that 60 percent of the overall market decline from March 19 through July 19 was attributed to the scandals.<sup>1</sup>

The authors also constructed a confidence interval around their base estimate. For the lower limit, they assumed that 25 percent of the market's decline from the March 19 close through the June 24 close was attributable to the scandals, but then assumed a 50 percent weighting for the decline between the closing values for June 24 and July 19. Thus for the entire March 19 through July 19 period, this yielded a net impact of 30 percent of the market's decline that could be attributed to the scandals. For the upper limit, the authors assumed that 75 percent of the decline in the March 19 to June 24 period was attributable to the scandals, but that 100 percent of the subsequent decline through July 19 was caused by the scandals. This yielded a net impact of 90 percent of the market decline.

Once the authors had determined how much of the market's overall decline during the study period could be attributed to the scandals, they could apply the weights to the actual rates of decline in the market to determine the overall fall in stock market wealth. In the base case, the assumption that the scandals accounted for 60 percent of the market's 28 percent reduction between March 19 and July 19 represented a 16.9 percent decline in wealth. For the lower limit of the confidence interval, the 30 percent assumption corresponded to a 10 percent decline in wealth, and for the upper limit the 90 percent assumption yielded an almost 24 percent decline in wealth.

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<sup>1</sup> These estimates of the percentage of market decline in stocks attributed to corporate scandals are, of course, averages of all stocks. For those companies with no involvement in irregularities, the percentage of their stock declined attributable to the scandals would be lower. For those companies who were at the heart of the massive accounting frauds, the percentage of their stock declines attributable to the scandals would be close to 100 percent.

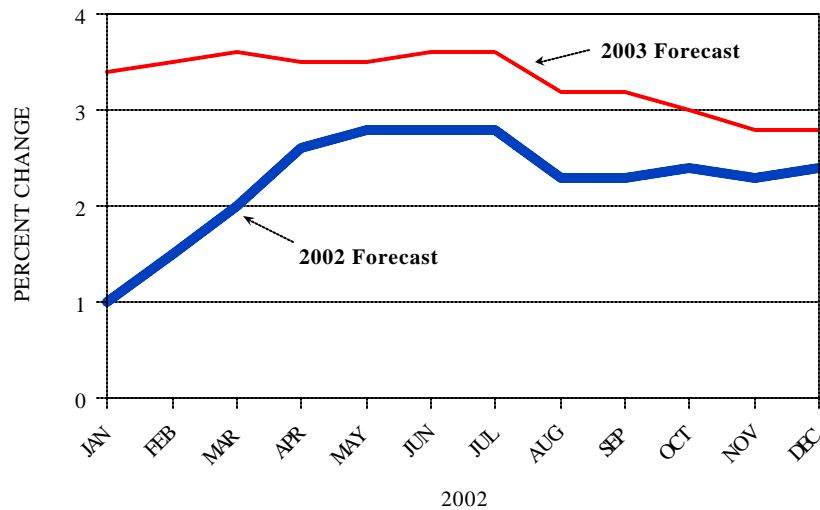
It is important to note that these estimates only represent the contribution that the scandals made to a decline in wealth and output. The declines in the financial markets due to the corporate scandals represent only part of the overall decline in the market since the end of the bull market in 2000. As noted earlier, the financial market decline between its August 2000 peak and its February 2003 low amounted to almost 44 percent, or 648 points. Looking at the cumulative impact of three years of stock market declines, and using the Federal Reserve's relationships between wealth and economic output, we estimate that about \$140 billion worth of GDP has been lost during this period. The corporate scandals clearly represent a major component of the lost output.

Brookings also looked at an alternate approach to check their estimates. Comparing the actual mid-2002 market performance with the expectations of Wall Street investment strategists as reported in a USA Today poll at the start of the year, Brookings found that the July 19 close was about 30 percent below the mean projection for the survey. Applying their low, base, and high assumptions about the amount that the scandals contributed to the market decline, and then using the Federal Reserve relationships, they calculated an alternate impact on GDP in the range of \$19 billion to \$57 billion.

Expectations for GDP growth in the national economy during 2002 diminished as the year progressed. The Blue Chip Economic Consensus Forecasts had plunged in the wake of the September 2001 terrorist attacks, but were gradually recovering; they reached 2.8 percent by May 2002 (see Figure 7). Amid rising public awareness of the corporate scandals and growing concerns that the economy may have stalled, these forecasts fell to 2.3 percent in August 2002 and remained near there for the rest of the year. During that time, there was an equivalent drop in the forecast for 2003, which showed that the expected impact would continue into the following year. The 2003 outlook continued to drop over the remainder of the year as war worries began to build.

An important consideration about these estimates, emphasized in both the Federal Reserve and Brookings Institution papers, is that a decline in wealth must be maintained for an extended period in order for the projected impact on the economy to be fully realized. To the extent that financial markets recover, they will again contribute to a gain in wealth. Over time, as businesses and consumers come to feel that the increase in wealth is real and not likely to reverse in the near future, they will modify their behavior toward increased consumption and investment. This will help diminish the long-term effect of the original decline in wealth.

**Figure 7**  
**Change in GDP Forecasts by Month During 2002**



Source: Blue Chip Economic Consensus

Recently, the financial markets appeared to have begun a period of recovery. Since the start of 2003, the Standard & Poor’s 500 Index has risen over 104 points or almost 12 percent (as of mid-August), although most of that recovery has only occurred since mid-March. If the recovery is sustained long enough to permanently affect investor and business behavior, it will begin to reverse the drag that three years of market declines have placed on the economy. However, the revenues lost by state and local governments as a result of the corporate scandals will not be recovered.

### **Impact on New York State**

The U.S. Commerce Department produces estimates of the state economies that are somewhat analogous to the GDP. While these gross state product (GSP) estimates are also inflation-adjusted, the most recent data does not continue past 2001. The national economic forecasting service Global Insight (formerly DRI-WEFA) has forecast that New York’s inflation-adjusted GSP totaled about \$790 billion in 2002—meaning that New York State accounts for about 8.4 percent of the nation’s output. Using the same assumptions as the Federal Reserve and Brookings Institution, we found that the corporate accounting scandals cost New York State’s economy \$2.9 billion. Given the Brookings estimate that the overall decline in stock market wealth between mid-March and mid-July 2002 that was attributable to the scandals ranged between 10 percent and 24 percent, the range for the economic impact on New York varied from \$1.8 billion to \$4.1 billion.

Over the last three years, New York State’s finances have reflected the changes in the economy. In general, lower economic activity and stock market wealth affects tax revenue collections by lowering business profits, reducing employment growth,

limiting personal income gains, and constraining consumption. State revenue losses in fiscal years 2001-02 and 2002-03, which amounted to \$8.7 billion, are attributable to the recession, the World Trade Center terrorist attack, and the downturn in the financial markets, which was worsened by the corporate accounting scandals.<sup>18</sup> Utilizing the weighting assumptions made by the Brookings Institution, we estimate that the accounting scandals contributed about \$1 billion to the State's revenues losses in calendar year 2002. The personal income tax took the largest hit, because of a significant decline in capital gains realizations. Reduced economic activity also contributed to somewhat lower business and sales tax collections.

Local governments throughout New York State also saw their revenues affected by the reduction in economic activity, as lower consumption spending reduced sales tax receipts. In New York City, which also levies personal and corporate income taxes, we utilized the Brookings assumptions to estimate that the corporate scandals reduced revenue collections in calendar year 2002 by about \$260 million.

### **Impact on the New York State Common Retirement Fund**

The decline in wealth that is due to the accounting scandals has an additional fiscal impact in that it has contributed to a dramatic increase in pension costs for the State and its local governments.

Although the recent improvement in the financial markets has begun to offset part of the cumulative impact of three years of economic and financial market decline, the impact on State revenues and pension performance is measured during discrete periods—the State fiscal year. While the recent market improvement may begin to change the behavioral impact of the earlier decline in wealth and affect the long-term impact of the scandals on the economy, the damage to revenues and the pension system during State fiscal year 2002-03 (April 1, 2002 through March 31, 2003) has already occurred, and future improvements in revenues or pension costs cannot ameliorate the actions needed to be taken to address the shortfalls in that particular fiscal year.

The New York State Common Retirement Fund (NYSCRF) contains the assets of the New York State and Local Employees' Retirement System, the New York State and Local Police and Fire Retirement System, and the Public Employees' Group Life Insurance Plan. The income derived from the assets helps pay the benefits for members of these systems, who are all employees of the State and local governments within the State (the City of New York, the New York State Teachers retirement fund, and the New York City Teachers retirement fund have their own pension systems and

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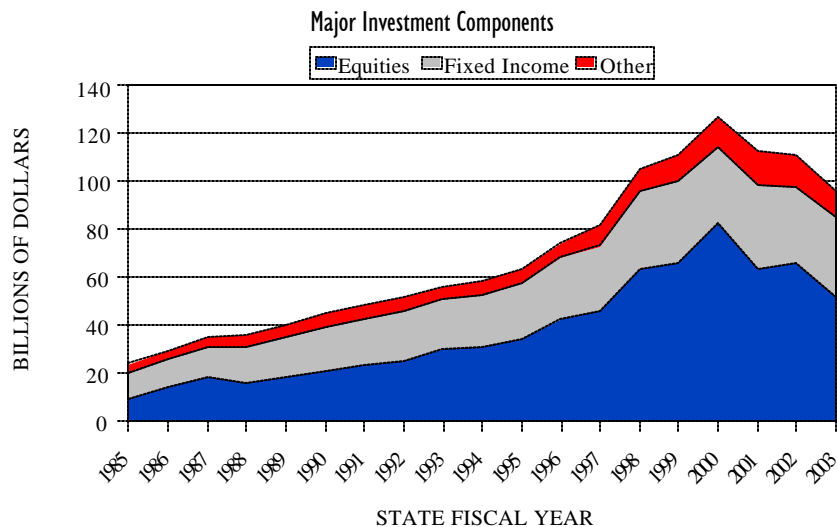
<sup>18</sup> For more detail on the factors contributing to the State's revenue losses, see *2003-04 Budget Analysis: Review of Economic and Revenue Forecasts*, New York State Office of the State Comptroller, March 2003.

are not members of NYSCRF). At the end of State fiscal year 2003, the NYSCRF held assets that totaled almost \$96 billion.<sup>19</sup>

The assets of the NYSCRF are invested in a variety of financial instruments. The largest category, equities (stocks), totaled \$51.6 billion at the end of State fiscal year 2003, representing about 54 percent of the Fund’s assets. Fixed income investments (bonds) are the next largest category, at \$34.1 billion or about 36 percent of assets. The balance of the NYSCRF assets are invested in such items as commercial mortgages, real estate, private equity, and foreign exchange.

NYSCRF assets grew sharply during the 1990s economic expansion (see Figure 8). In 1990, assets totaled \$45.2 billion and increased to \$127.1 billion by the peak in 2000. The cause of this expansion was in large part because of the tremendous growth in equities, due to the bull market of that period. Equity investments grew from \$21.1 billion in 1990, or 46.7 percent of the Fund’s assets, to \$82.7 billion in 2000, or 65.1 percent of assets. While the Fund’s assets increased by 181.4 percent during the 1990s, its equity investments grew by 291.7 percent.

**Figure 8**  
**NYS Common Retirement Fund**



Source: NYS Comptroller's Office

Since 2000, the assets of the Fund have declined in value, paralleling the weakening of the financial markets. By the end of State fiscal year 2003, the assets of the Fund had declined to just under \$96 billion, a drop of 24.7 percent. Most of the Fund’s \$31 billion decline during this three-year period occurred in the equity component. About half of the equity loss occurred in the most recent year, as the financial markets declined because of the corporate accounting scandals and anxiety over the approaching war with Iraq.

<sup>19</sup> All values for the NYSCRF in State fiscal year 2003 are unaudited, preliminary estimates.

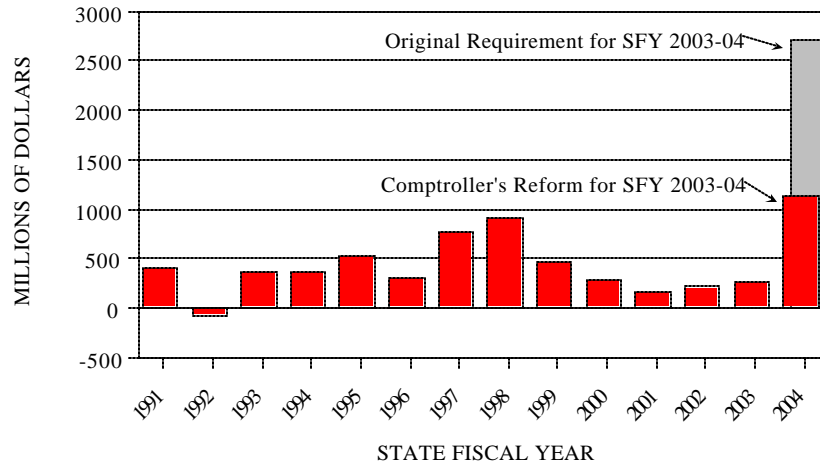
Between March 31, 2002 and March 31, 2003, the Standard & Poor's 500 Stock Index declined by 26.1 percent. In the Brookings analysis, the estimate of the scandals impact looks at the 27.6 percent decline in the index between March 19, 2002 and July 19, 2002. However, by the end of State fiscal year 2003, war worries and then war rallies had returned the market to the same level it was at on July 19, 2002 (an index level of 848.2 on March 31, 2003 compared to 847.8 on July 19, 2003). Thus, much of the decline in the NYSCRF in State fiscal year 2003 can be traced to movement in the markets between March and July 2002. Using the same assumptions in the Brookings Institution's August 2002 policy brief, we found that the corporate accounting scandals could have contributed a base estimate of \$9.1 billion toward the NYSCRF's \$15.4 billion loss in State fiscal year 2003, with a range between \$4.6 billion and \$13.7 billion given their alternate assumptions.

### **Impact on State and Local Budgets**

To determine employer contribution levels, actuarial calculations require assumptions regarding future investment returns, salary growth, probabilities of retirement, death, etc. If the system falls short of its assumed rate of return, the government entities that participate in the system must increase their financial contributions to make up for the shortfall in investment dollars. The sharp rise in the value of the NYSCRF in the late 1990s allowed the system to reduce the contributions needed from the State and its local governments—because surging stock earnings exceeded the required rate of return. However, the declines in the value of stock investments since 2000 now require the State and its local governments to increase their contributions to the Fund (see Figure 9).

Because the required contributions from the State and its local governments have to increase rapidly to offset the investment shortfall, government budgets across the State face considerable hardships. As a result, the Comptroller proposed and the State Legislature adopted several reforms to the retirement system. Rather than allowing contributions to decline to very low levels during periods of high market growth, a minimum contribution (4.5 percent of payroll) will be required. Since employer contribution levels can exceed 10 percent of payroll during downturns in the market, any additional contributions made during high market growth periods will reduce the payment requirement when the market falls. Contributions would also lag behind investment results by one year, giving the State and the local governments' additional time to budget for changes in contribution levels. The Fund uses a five-year weighted average when determining the level of contributions. Thus, the increased contributions arising from losses in the prior three years would first be due in State fiscal year 2005 instead of State fiscal year 2004.

**Figure 9**  
**State and Local Government Employer**  
**Contributions to the Common Retirement Fund**



Contributions are shown for the year paid, and reflect prior year's investment experience.  
 Sources: NYS Comptroller's Office; Retirement System annual report

For the State, the decline in the pension fund would have resulted in a \$1.1 billion contribution to the system in State fiscal year 2004, compared to the \$138 million contribution in State fiscal year 2003. The Comptroller's reforms introduce a one-year lag, effectively changing the billing cycle for employers; contributions will now use the Fund's value on the prior April 1. Thus, the State will make a \$480 million payment in State fiscal year 2004, based upon the Fund's value on April 1, 2002. The basis for the State's contribution for fiscal year 2005 will be the value as of April 1, 2003 (yielding the \$1.1 billion contribution), so no subsequent financial recovery will affect this payment.

The budgetary impact of the investment shortfall is also high for many local governments. Overall, local governments in New York State—counties, cities, towns, villages, and school districts—faced a net 2,122 percent increase in their pension contribution, to \$1.6 billion. However, the size of a local government entity does not help predict the impact of the increased contribution on its budget. For example, the impact could be equally burdensome for a small county like Lewis or a large city such as Rochester (see Figure 10). The Comptroller's reforms will reduce the shortfall's impact on local governments by lowering the required payment this year to about \$650 million. Nonetheless, payments would still rise compared with the previous year, because the minimum payment of 4.5 percent of payroll would apply.

**Figure 10**  
**State Fiscal Year 2004 Pension Contributions**

<b>Type of Entity</b>	<b>Name</b>	<b>Original Requirement</b>		<b>Comptroller's Reforms</b>	
		<b>Contribution (\$ Million)</b>	<b>Percent Change</b>	<b>Contribution (\$ Million)</b>	<b>Percent Change</b>
Small County	Lewis	\$2.36	1,164.5%	\$1.01	495.1%
Large County	Westchester	\$38.88	1,158.1%	\$16.10	479.6%
Small City	Elmira	\$1.83	3,728.5%	\$0.63	1,287.3%
Large City	Rochester	\$22.62	1,009.3%	\$8.74	390.2%
Small Town	Alfred	\$0.02	1,196.4%	\$0.01	492.7%
Large Town	Oyster Bay	\$6.09	1,179.0%	\$2.54	492.6%
State	New York	\$1,100.0	697.1%	\$480.0	247.8%

Source: NYS Comptroller's Office

New York State's pension system is not alone in suffering investment losses due to corporate scandals and the general economic slowdown. Because the fiscal year in many states ends on June 30, rather than on March 31 as in New York State, the recent recovery in the financial markets gave many other states time to recover some losses and reduce their pension losses (New York City's pension system, for example, was able to benefit in this way). However, though the fiscal blow was softened it was not eliminated, and many states still reported sizable pension investment losses and a corresponding sharp rise in required pension contributions. In many states, contribution rates are set by statute and many lag behind the implementation of new contributions, although the lag can vary from two months to three years (most are between 6 and 12 months). The amount of increased contributions is placing severe fiscal burdens on many state and local governments, and several are considering plans to bond out their increased pension liabilities. Several more have already taken action to bond out pension liabilities (either those arising from this year's shortfalls or those where the current shortfall has dramatically added to a pension system's underfunding), including a \$2 billion dollar issuance in California, a \$10 billion issuance in Illinois, and a \$500 million issuance in Kansas. West Virginia is considering a \$3.9 billion offering to bond out its unfunded liability, and Wisconsin is considering a refinancing of some of its pension liability.

New York City has its own pension system, which includes the New York City Employees' Retirement System, the Teachers' Retirement System, the Board of Education Retirement System, the Police Department Pension Fund, and the Fire Department Pension Fund. The City's pension system also suffered from the market declines of the last few years, including the declines attributable to the corporate scandals. Because the City's fiscal year ends on June 30, the market rally that began in March 2003 has lessened the pension system's losses in City fiscal year 2003. Nonetheless, the City still faces increased pension contributions in future years to cover the recent declines in its pension system's values and its earnings shortfalls.

Restating the City’s pension fund system’s performance to a State fiscal year basis shows that the assets of the system declined from \$81.5 billion on March 31, 2002 to \$70.2 billion on March 31, 2003, a decline of \$11.3 billion or 13.9 percent. This performance is similar to that of the NYSCRF. Utilizing the Brookings Institutions allocation assumptions in the same way they were applied to the NYSCRF, we estimate that under the baseline assumption the City’s pension system lost \$6.8 billion in value due to the corporate scandals. The overall range for the loss attributable to the corporate scandals was from a low of \$3.4 billion to a high of \$10.2 billion.

### Impact on 401(k) Holders

While the corporate scandals contributed to significant losses for public pension systems across the nation, these shortfalls will not have an impact on the benefits that pension system participants can expect to receive. However, the scandals did contribute to a significant decline in the value of individual investors’ portfolios, and given the increased importance equity investments play in the retirement savings of most Americans, many individuals will see a reduction in the benefits they hoped to be able to live on (see Figure 11). For example, according to the Employee Benefit Research Institute, the average value of a 401(k) portfolio for participants aged in their fifties was about \$92,500 in 2001.<sup>20</sup> Approximately 70 percent of this portfolio was invested in stocks or stock-related funds. Utilizing the Brookings assumptions, we estimate that during the mid-March 2002 through mid-July 2002 period, the corporate scandals accounted for a loss of about \$10,700 to this average portfolio, a decline of 11.6 percent.

**Figure II**  
**Impact of Scandals on Average 401(k) Portfolios**

Age Cohort	Average 401(k) Portfolio Balance in 2001	Share in Stock-Related Investments	Average Dollar Impact	Average Percent Change
30s	\$34,900	83%	(\$4,760)	-13.6%
40s	\$62,900	78%	(\$8,090)	-12.9%
50s	\$92,500	70%	(\$10,770)	-11.6%
60s	\$109,000	58%	(\$10,450)	-9.6%

Sources: Employee Benefit Research Institute, OSC analysis

<sup>20</sup> Holden, Sarah and VanDerhei, Jack, *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2001*, Employee Benefit Research Institute Brief Number 255, March 2003.

## Class Action Litigation

To the extent that the decline in the value of individual corporations was caused by fraudulent or criminal activities, both individual and institutional investors have the option of litigation as a means of recouping part of their investment losses.

In 1995, Congress passed the Private Securities Litigation Reform Act (PSLRA), which enables large institutional investors that have suffered heavy losses to serve as lead plaintiffs in securities litigation. Prior to the enactment of the PSLRA, institutional investors, including public pension funds, often took a passive role when securities fraud was uncovered in a corporation. Small private investors brought the vast majority of securities fraud class action lawsuits against corporate defendants. In the years following the enactment of the PSLRA, more and more institutional investors, including the NYSCRF, have sought and obtained lead plaintiff status and aggressively litigated securities class actions in federal court.

Since passage of the PSLRA, NYSCRF has been appointed lead plaintiff in six securities fraud class actions and one shareholder derivative action. This litigation includes class actions against Cendant Corporation, Chubb Corporation, McKesson HBOC, Raytheon, WorldCom, and Bayer. In these six cases alone, NYSCRF experienced losses of more than \$440 million. The Cendant Corporation class action reached a settlement in 1999; the remaining five class actions are in various stages of litigation. NYSCRF is also lead plaintiff in a shareholder derivative suit on behalf of Columbia/HCA Healthcare Corporation entitled *McCall v. Scott*.<sup>21</sup>

As lead plaintiff in a class action, NYSCRF has a fiduciary duty to the members of the class to maximize the recovery of damages suffered by the class as the result of fraud or other compensable misconduct in the sale of securities. Separate and apart from the recovery of damages, NYSCRF seeks, when appropriate, to obtain positive corporate governance changes from the companies involved in the litigation in order to protect shareholders in the future and to promote public confidence in the market place. NYSCRF has included corporate governance reform in settlement negotiations with defendant corporations in an effort to improve and strengthen its management in the future. One reason this is particularly important is because NYSCRF and many other class members frequently continue to hold stock in the corporation.

Following is a brief review of each of the six class actions for which NYSCRF is lead plaintiff.

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<sup>21</sup> Since it is a shareholder derivative suit, any recovery from this litigation will go directly to the company and not to the shareholders. Therefore, NYSCRF has not alleged any damages to itself in this matter. However, NYSCRF has negotiated a \$14 million settlement from insurance proceeds along with significant corporate governance reforms for the company, which should leave it in a stronger position for the future.

## **Cendant Corporation**

The first class action for which NYSCRF served as a lead plaintiff under the PSLRA, *In re Cendant Corporation Litigation*, resulted in a \$3.2 billion settlement, the largest recovery by far in any securities class action in history. NYSCRF served as co-lead plaintiff with the New York City Pension Funds and California Public Employees' Retirement System (CalPERS).

In 1997, the merger of CUC International and HFS International formed Cendant Corporation. Cendant is one of the world's largest consumer and business service companies, encompassing several well-known businesses such as Avis, Century 21, Howard Johnson, and Ramada Inn. In April 1998, Cendant announced that it had uncovered accounting irregularities and was restating its financial statements for 1997 to reflect a reduction of more than \$100 million. This caused its stock prices to drop sharply. More restatements for 1995 and 1996 followed and stock prices fell further.

The class action complaint alleged that from 1995 to 1998, CUC/Cendant issued a series of materially false and misleading financial statements that artificially inflated stock prices. The complaint also alleged that Ernst & Young, which was CUC's auditor prior to the merger and creation of Cendant, had failed to adhere to Generally Accepted Auditing Standards (GAAS) and lacked a reasonable basis for its opinions and reports. Overall, Cendant shareholders lost more than \$8.5 billion. NYSCRF alone lost over \$34 million.

On December 7, 1999, the parties announced a settlement with Cendant in excess of \$2.8 billion. In addition, Cendant agreed to institute significant corporate governance changes. On December 17, 1999, another settlement of \$335 million was reached with Ernst & Young, for a total recovery of \$3.2 billion. Of the total cash settlement, the average recovery for each claimant was about 38 percent of that claimant's damages as calculated by the Claims Administrator. As its share of the Cendant recovery, NYSCRF will receive approximately \$13.3 million from the cash settlements.

## **McKesson HBOC**

In *In re McKesson HBOC, Inc. Securities Litigation*, NYSCRF has losses of about \$56.6 million. Prior to 1998, McKesson Corporation was a San Francisco-based distributor of medical, surgical, health, and beauty supplies. HBOC Corporation provided software for the health care industry and was located in Atlanta. In 1999 the two companies merged; HBOC became a wholly owned subsidiary of McKesson, and McKesson was renamed McKesson HBOC.

The complaint alleges that defendants in both companies engaged in accounting fraud and that HBOC's accounting statements were materially false and misleading. The accounting improprieties were evident in both HBOC's financial statements and in a joint proxy statement for the merger. After the merger, McKesson HBOC announced that it was restating its financial results for 1997, 1998, and 1999, and reversed millions of dollars of improperly recognized revenues. The value of McKesson HBOC stock fell significantly, causing stockholders to suffer huge losses. The complaint alleges that, in addition to the HBOC and McKesson defendants, Arthur Andersen (HBOC's auditors) and Bear Stearns (McKesson's financial advisor) had knowledge of the accounting improprieties but failed to disclose it.

## **Raytheon**

In another class action, *In re Raytheon Company Securities Litigation*, NYSCRF suffered losses of approximately \$30 million. Raytheon Company provided products and services in the areas of defense and commercial electronics, business and special mission aircraft, and engineering and construction. The complaint alleges that Raytheon defendants issued materially false and misleading statements that used accounting manipulations to deceive the investing public as to the company's financial performance. It further alleges that the company failed to disclose that a number of its key government defense projects were materially behind schedule and over budget, and that it was suffering from a critical shortage of engineers to work on its government contracts. When the company finally disclosed the true financial information, the price of Raytheon stock fell substantially and remained depressed; stockholders have subsequently lost several billions of dollars. In addition, the complaint alleges that PricewaterhouseCoopers, Raytheon's auditing firm, issued a materially false and misleading audit opinion that the financial statements had been prepared in accordance with Generally Accepted Accounting Principles (GAAP).

## **WorldCom**

NYSCRF, the court-appointed lead plaintiff in *In re WorldCom, Inc. Securities Litigation* and the related *WorldCom Analyst Litigation*, lost more than \$300 million. WorldCom is a large telecommunications company that acquired other communications companies, including MCI. Because of its bankruptcy, WorldCom cannot be named as a defendant, but the complaint alleges that WorldCom executives overstated the company's earnings by over \$11 billion in order to inflate revenues and profits. The accounting fraud included drawing down reserves that WorldCom had taken when it acquired other companies, and transferring expenses away from the category of operating expenses and into the category of capital project accounts so that there would be no deduction of such costs from current period revenues. These transfers had no underlying support and violated GAAP. Four former WorldCom executives have pled guilty to criminal charges in connection with the fraud. The

complaint also alleges that Arthur Andersen, WorldCom's accountant, knew or should have known of the fraud and failed to disclose it. With the discovery of the fraud the value of WorldCom stock and bonds fell, and stock and bond purchasers suffered substantial losses on their investments.

Moreover, the complaint alleges that Salomon Smith Barney (SSB) and its star analyst, Jack Grubman, entered into a conspiracy with WorldCom executives to help the company raise billions of dollars and make more acquisitions. SSB and Grubman gave WorldCom glowing analyst reports in exchange for huge investment banking fees. WorldCom executives also personally received valuable initial public offering shares in companies for which SSB was the underwriter. Former WorldCom CEO Bernard Ebbers received huge personal loans from Travelers Insurance Company, owned by SSB's parent corporation, Citigroup. Ebbers' WorldCom stock secured the loans. Thus, it is alleged that Citigroup had an incentive to keep the value of WorldCom stock high and continue its positive analyst reports.

Finally, the complaint alleges negligence claims against the defendants who served as underwriters on WorldCom's huge bond and note offerings, which were sold to the public pursuant to false and misleading registration statements.

### **Chubb Corporation**

NYSCRF is serving as co-lead plaintiff, along with CalPERS, in *CalPERS v. The Chubb Corporation*, which is pending in the U.S. District Court for the District of New Jersey. Chubb Corporation is a large insurance company that merged with Executive Risk, a more profitable insurance company, in 1999. The complaint alleges that Chubb and Executive Risk defendants devised a scheme to artificially inflate and stabilize the price of Chubb stock for the purpose of: (1) securing the approval of Executive Risk shareholders to the merger; (2) avoiding a takeover of Chubb; (3) enabling Chubb executives to retain their positions and compensation; and (4) enabling Executive Risk defendants to receive millions in special benefits and payments after the merger. Defendants purportedly gave false and misleading statements that masked serious problems and large losses in Chubb's commercial insurance business. As alleged in the complaint, Chubb executives falsified financial statements to make revenues appear higher than they were. Days after the acquisition of Executive Risk, Chubb announced that profits were worse than expected due to increased losses, and it appeared as though defendants waited to disclose Chubb's poor financial results until after Executive Risk shareholders had voted in favor of the merger. Chubb's stock plummeted and purchasers of Chubb stock, including Executive Risk's former shareholders, lost millions of dollars. NYSCRF lost approximately \$657,000.

## **Bayer AG**

Most recently, NYSCRF was appointed lead plaintiff in a class action against the German pharmaceutical company, Bayer AG, and certain of its officers and directors. The action is pending in the Federal District Court for the Southern District of New York for alleged violations of federal securities laws. The complaint alleges that Bayer AG misled investors by making false and misleading statements about strong sales and continuing earnings as a result of the addition of Baycol, the company's new cholesterol-lowering drug, to its product line. It is alleged that Bayer executives made materially false and misleading statements predicting increased sales of Baycol, even though they knew that Baycol had been linked to life-threatening side effects or even death. The suit alleges that Bayer executives were aware that Baycol presented serious health risks to patients long before the company finally withdrew the drug from the market. It also alleges that investors lost millions of dollars; NYSCRF alone lost approximately \$22 million as a result of the company's misrepresentations.

## **Going Forward**

NYSCRF applied for lead plaintiff status in the *Global Crossing Ltd. Securities Litigation*; its approximate losses in *Global Crossing* were \$75 million. However, the court recently appointed the Ohio Pension Group as lead plaintiff because it was found to have had larger financial losses than NYSCRF. In any event, NYSCRF will remain a member of the class of plaintiffs and will share in any recovery.

NYSCRF is also a class member in numerous other class actions that allege securities fraud in courts across the nation. NYSCRF remains dedicated to maximizing the recovery of losses resulting from corporate fraud in the public securities market. Following the corporate fraud uncovered in Enron, WorldCom, and other companies, NYSCRF will aggressively litigate class actions and seek corporate governance reforms in order to protect investors and help restore public confidence in the market place.

Greater corporate governance is needed to ensure accurate financial reporting, restore investor confidence in the market, and stimulate long-term market growth. To achieve this, the NYSCRF is working to establish a reform agenda, the goal of which is not to eliminate risk (which is an inherent characteristic of the stock market), but to ensure that risks associated with the dissemination of false corporate information are eliminated to the greatest extent possible. While the SEC and other oversight entities have begun to implement reforms on Wall Street, including Congress' passage of the Sarbanes-Oxley Act of 2002, more must be done. It was not until late 2002 that government and business reacted to the corporate scandals, and by then they did little to allay investors' fears. So far, action has been sporadic and has yet to increase confidence in the market, although it must be noted that the war in Iraq has also

contributed to the recent skittishness of investors. The tax cuts on dividends and capital gains, plus better earnings and improving economic news, are now lifting the markets, and better governance will help build on this trend. To restore faith in the market, a comprehensive reform agenda must be implemented to ensure accurate financial reporting, corporate executive accountability, the creation of independent boards of directors, and the ability of shareholders to initiate change. Until this occurs, confidence in the market will not return and investors remain vulnerable to the same scandals and pitfalls experienced throughout the past five years.



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