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Pay-To-Play: A Class Action Connection?

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12.16.09, 03:45 PM EST

Public pensions fail to ask tough questions about fee splits.



An offer of \$800,000 up front and 10% of any class action legal fees: That's what law firm Milberg Weiss Bershad Hynes & Lerach proposed paying me in July 2003 to serve as its Marketing Director.

As the nation's preeminent securities class action law firm, Milberg Weiss was in the business of suing companies for misdeeds, real and otherwise. Its suits have targeted dozens of companies, including JPMorgan Chase (JPM – news – people), Prudential Insurance, Merrill Lynch, now a unit of Bank of America (BAC – news – people), and Allegheny Energy (AYE – news – people)

By the time it contacted me, the New York-based firm was close to splitting with its San Diego office. Along with the West Coast operation would go the local lead partner, William Lerach, much of the lucrative business of suing Silicon Valley tech firms and virtually all of the marketers who drummed up the combined firm's clients.

Making matters worse for Milberg Weiss, by 2003 it had a serious legal issue on its hands—an ongoing criminal investigation by the federal government. The Department of Justice has yet to take any action, but Milberg Weiss' relationships with clients—mostly big public and union pension funds—were already strained.

That's where the firm apparently thought I could help out. After working for the Securities and Exchange Commission, I'd spent two decades advising pension funds on investigating financial wrongdoing among money managers and had connections to the union members, cops, firefighters and various others who oversee such funds. Milberg Weiss' offer had obvious financial appeal. However, I wasn't about to risk getting involved in criminal activity, regardless of the monetary incentive.

The Milberg Weiss founders with whom I met in New York assured me repeatedly that any questionable behavior at the firm was strictly related to its West Coast office, about which they said they knew little. Their claims were less than assuring, given that I'd heard the West Coast operation was telling clients similar stories about New York.

Being new to marketing of legal services, I was struck to see how law firms compete. Money managers do so by trying to offer innovative products and strong investment performances, which are disclosed in industry databases. Since lawyers' win-loss records are hard to make sense of, they often rely on a softer sell in which claims of high integrity are a big part of the marketing pitches.

The other major influence on how class action firms sell themselves is a 1995 law which encourages judges to appoint investors with the biggest losses as the so-called named plaintiffs--the aggrieved parties with legal authority to call the shots for all the other class members who owned a stock and are suing over alleged wrongdoing. This law, known as the Private Securities Litigation Reform Act, sent the big class action firms into a fierce fight to curry favor with the institutional investors most inclined to sue corporations--meaning a litigious group of mostly union and public pensions funds.

One way the law firms do this is by sponsoring cushy pension fund conferences. While class action lawsuits are a mere sideshow to the many issues pension fund trustees must consider, the firms seeking to represent them in such matters often underwrite half or more of conferences in exchange for prominent promotion of their services. Their role has become even more prominent as the cost of such sponsorships has topped \$50,000 and many big asset managers have cut back, either due to the cost or to allegations that such promotions are inappropriate.

When I met with the Milberg Weiss partners in New York, they discussed marketing via industry conferences, approaching pension officials directly and what was described as the most cost-effective method of all--paying commissions to local agents for lining up business. By agents, they meant local lawyers who represent pensions in other matters and are supposedly motivated solely by the best interests of their clients.

Many, however, are also eager to supplement their legal practices with hefty class action referral fees and other compensation. In my opinion, if local fund counsel is promised contingent fees for reeling in class action business, its advice risks becoming conflicted. That financial conflict should, at minimum, be disclosed.

I asked the Milberg Weiss partners whether public pensions were told of payments made to local fund counsels. A laugh went through the room "We won't answer that question until you join the firm," I was told. Those were not conditions under which I was willing to move forward, so I headed back home to Florida.

In a written statement, Milberg LLP, a successor of Milberg Weiss Bershad Hynes & Lerach, declared: "No one currently at our firm, Milberg LLP, knows anything about allegations made by Mr. Siedle or the conversations to which he refers. The 'partners' he refers to are no longer with the firm. In general, we believe there is nothing wrong with offering an attorney a job with a salary plus incentives or paying fees for legitimate outside referrals. But we know nothing about the specific actions described by Mr. Siedle."

The following year, Milberg Weiss did split into two firms: New York-based Milberg LLP and San Diego's Coughlin Stoia Geller Rudman & Robbins. Three of the partners I'd spoken with went to jail for unrelated criminal activities involving class action clients.

Since then, I've urged public pension officials to scrutinize the arrangements they enter into with class action law firms, just as they vet investment consultants, money managers, brokers and anyone else doing business with their funds. Nevertheless, scrutiny of lawyers by public pensions remains severely lacking--and not just among pension officials.

New York Attorney General Andrew Cuomo recently has been going after allegedly crooked investment consultants for bribing their way into doing business with the state's giant pension fund. However, Cuomo has stated that he won't be subjecting class action firms (from which he has reportedly received large campaign contributions) to similar scrutiny for similar behavior.

When properly motivated, I believe class action lawsuits provide necessary checks and balances in our financial system. But given how widely they're misused, I've also urged the Department of Justice to look into potential abuses. As it exists today, the marketing of class action legal services to public pensions is damaging both the participants in the funds and the taxpayers who underwrite them.

Edward Siedle is a former SEC attorney and the president of Benchmark Financial Services.