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What's Next: The Plaintiff's Perspective - The Granddaddy of All Derivatives Suits

Larry Smith | July 01, 2009

In this regular feature, Bulletproof interviews top plaintiffs' attorneys for their perspective on the crises likely to affect businesses in the near future. Today we talk to Frank P. DiPrima of the Law Office of Frank DiPrima in Morristown, NJ. Mr. DiPrima has been co-counsel in the derivative law suit against Richard Scrushy, founder of HealthSouth Corporation.

In its June, 2009, decision in Wade Tucker v Richard Scrushy et al., an Alabama court awarded plaintiffs \$2.876 billion, reportedly the biggest judgment ever against an executive. It was, in any event, the largest shareholder derivative lawsuit in history, climaxing a series of successes that, in 2006, included summary judgment forcing Scrushy to pay back \$53 million in incentive bonuses, recoveries in settlement of \$100 million from outside directors, and \$133 million from an investment bank advisor. Mr. DiPrima and his co-counsel, the Birmingham, Alabama firms of Hare Wynn Newell & Newton, and Galloway & Somerville, prosecuted these cases from their inception.

Where are the lessons for business in this extraordinary saga, and what does the entire HealthSouth case portend for the future?

Frank DiPrima: First, outside directors cannot co-invest or set up separate entities with the executives whom they are supposed to oversee. That's what happened at HealthSouth until 2003 – Scrushy created third party, self-dealing entities with HealthSouth assets and cut in a few of the “independent” board members. That may be why Scrushy thought his board would overlook his activities rather than oversee them.i,

Second, Scrushy and his management were driven by a vicious cycle of giving “guidance” that creates Wall Street earnings expectations, feeling pressure to meet those expectations, and then creating higher “guidance.” Scrushy responded by committing fraud. Whatever the gap was between real earnings and those the Street expected, he fabricated. Weaker people in his management went along.i,

There is an endemic problem here. I have no answer, but this case exposes “giving guidance” as really giving pressure and temptation. Boards of newly public companies not already giving “guidance” should think long and hard before authorizing such practice. It has consequences.

Third, successful entrepreneurs who take their companies public are journeying into a strange new world. Scrushy always thought of HealthSouth as his company, because he founded it.i, Many honorable founders of public companies instinctively think the same way. The directors must remember not to yield to an overwhelming personality and to take their oversight duties seriously. The entrepreneur must encourage real oversight.

What does Scrushy's earlier bonus disgorgement suggest for the future, in terms of executive compensation and clawbacks?

Frank DiPrima: Plaintiffs lawyers watch for compensation based on questionable accounting. We look for compensation awarded on the basis of an earnings statement that has since been invalidated.

Two points grow from that. First, companies need effective audit committees, comp committees, and governance structure. Absent that, shareholders have every reason to look back and question why they awarded incentives when events prove that the predicate on which incentive compensation was awarded is invalid.

Second, companies should rethink single-year bonuses. If we pay people to achieve single-year results, and pay them as soon as the year is over, they are not going to think about the following year.i,

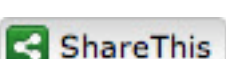
What do you see as the future of derivative suits?

Frank DiPrima: I doubt Mr. Scrushy has \$2.8 billion to fork over to HealthSouth but the financial redress for the company has been quite significant since all this started. Vindication for HealthSouth and its constituencies has been perhaps even more important. I hope corporations will respond collaboratively to shareholders' counsel in future derivative lawsuits. There's an obvious mutuality of interest.i,

Remember too, shareholders' derivative recoveries in this case were possible only because the company avoided bankruptcy. Successful post-disaster restructurings will inspire more shareholders to take a closer look at what happened, assess responsibility, and seek their day in court.

Finally, as securities case precedents have made it more difficult to hold third-party advisors, such as bankers, accountable to shareholders, derivative suits will become a more important vehicle for seeking redress from outside firms that allegedly aided fiduciary wrongdoing.

Larry Smith is Senior Vice President of Levick Strategic Communications and a contributing author to Bulletproof Blog.



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