



Bulletin

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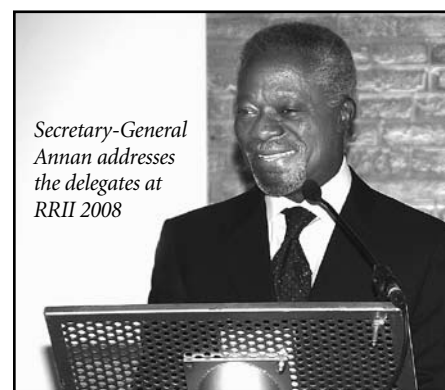
KOFI ANNAN INSPIRES DELEGATES AT THE THIRD ANNUAL RIGHTS & RESPONSIBILITIES OF INSTITUTIONAL INVESTORS SEMINAR

By: *Darren J. Check, Esquire*

On March 13th, More than 100 Delegates from Around the World Gathered in Amsterdam to Examine and Debate Current Issues Affecting Institutional Investors

Former U.N. Secretary General Kofi Annan drew passionate applause as he reminded delegates how critical their role was in both world politics and economics. His appearance was the climax of the Rights & Responsibilities of Institutional Investors Seminar, the theme of which was, "Benefiting from Responsible Investment and Active Engagement." The seminar was hosted by Schiffrin Barroway Topaz & Kessler and Institutional Investor.

For the third year top-level executives, legal counsel, compliance and corporate governance officers, from pension funds, mutual fund managers, insurance companies, hedge funds, as well



Secretary-General Annan addresses the delegates at RRII 2008

as politicians and financial service providers from around the world listened and participated in dialogue on current shareholder issues. With attendees from throughout Europe, the United States, Asia, South America, and Australia there was a potent discussion concerning fiduciary responsibility and the role of investors, regulators and others in overseeing the capital markets. Some highlights of the day's program are as follows:

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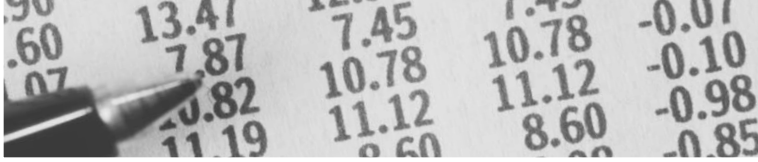
THE CURRENT STATE OF STOCK OPTION BACKDATING LITIGATION

By: *James H. Miller, Esquire*

On March 18, 2006, *The Wall Street Journal* published an article entitled "The Perfect Payday," which identified a scandal whereby the directors and officers of numerous companies deliberately backdated to themselves stock option grants with historically low exercise prices. This article, and other concurrent academic publications, prompted SBTK to undertake a comprehensive review of the stock option granting practices of nearly 100 public companies.

SBTK has been appointed lead counsel in more than 50 derivative actions across the country, and has already helped recover millions of dollars for, and improve the corporate governance practices of, many of these companies. Meanwhile, in the more-than two years since the stock option backdating scandal unfolded, the case law has developed to clearly establish the liability of directors and officers who manipulated their fiduciary po-

(Continued on page 8)



David A. Schwerin, Ph.D. is President of the Institute for Ethical Awareness, a member of the advisory board of Saint Joseph's University's Arrupe Center for Business Ethics, a visiting Professor at Tianjin University of Commerce in Tianjin, China, and an international speaker on ethics, CSR and related topics. The author of two books and numerous articles, David headed an investment counseling firm for over 30 years.

HIDDEN DAMAGES

By: David A. Schwerin, Ph.D.

Unethical and illegal acts cause harm — on that, there is wide agreement. Unfortunately, we tend to zero in on the financial fallout and ignore far more insidious and detrimental consequences. For example, if an executive provides the public with misleading financial information, investors are unfairly disadvantaged. If, as is often the case, the offending company has to retrench or even fold, the circle of destruction widens. Trusting suppliers may now go unpaid and customers, whose after-sale service is jeopardized, will likely suffer. More seriously affected are employees whose psyches are shattered when anticipated job and retirement security vanishes. But this is just the tip of the iceberg. What may not be so obvious is the damage inflicted on a wide range of associated individuals. Employee stress levels can transfer to the family as bills go unpaid and the job search lingers on. Tensions rise and children are caught in the middle of angry, depressed parents. If prolonged, the tension can lead to a broken family and dysfunctional children. Friendships often disintegrate and the local community, dependent on the crippled firm for tax revenue, faces a budget out of kilter. The ripple effects are unending.

My second book, *Conscious Globalism*, dissected the Enron scandal in detail. Now that more than half a dozen years have passed, it's instructive to reexamine the scope of the damages. An article in *USA Today* entitled, "Enron woes reverberate through lives," documents some of the domino effects. Darlene Roberts, wife of laid-off Enron employee Dale Roberts, was disabled and unable to work while her husband searched over two years for a new job. It was both devastating and humiliating. According to Darlene, "it caused physical and mental anguish and it caused stress on our marriage." Steve Lacey worked for Portland General Electric, which Enron purchased in 1997. The experience, says Lacey, "made me a pretty bitter American citizen. But if you dwell on it, it will ruin the rest of your life." In 2001, Tom Padgett, 63, was closing in on retirement. He and his wife, Karen, planned to spend their retirement operating a ranch for disabled children.

Those plans had to be scrubbed. The stress worsened Karen's rheumatoid arthritis and has had an emotional impact on both of them. "Some days are good, and some are bad," says Tom. "They're bad when we sit and think about what we could have done." And who doubts that the sudden death of Enron's CEO, Ken Lay, was related to the stressful environment surrounding the company's disreputable activities. Was his fear of the future too much to bear? Dr. Martin Samuels, professor of neurology at Harvard Medical School, believes that if the fear factor is strong enough anyone can be scared to death.

Whether stressful events lead to an extreme result or something less dramatic, the tension and anxiety created by destructive, unethical choices are more threatening to our health than generally realized. Cortisol is a hormone released by the adrenal glands when a person is stressed. When the body is flooded with stress hormones, cortisol levels become elevated and health and well-being suffer. Stress reduces the immune system's ability to protect against infection, causes cognitive impairment, insomnia, depression and abdominal fat. These conditions can increase the risk of liver disease, diabetes and high blood pressure.

Andrew Newberg, associate professor of Radiology and Psychiatry at the University of Pennsylvania, states that, "stress can undermine every aspect of our cognitive and emotional stability and the longer we remain stressed the more it alters our perception of reality." A person with a distorted view of reality is a danger to everyone.

Until now, very little attention has been paid as to the effect unethical and illegal behavior has on health and well-being. The Institute for Ethical Awareness (www.instituteforethicalawareness.org) is conducting research to document this potentially pernicious relationship. Once this relationship is verified, those seeking reparations for disreputable activities will be able to evaluate a wider variety of potential damages and have a correspondingly greater impact on society's welfare.

SECOND CIRCUIT AFFIRMS “CORPORATE SCIENTER” DOCTRINE

By: *Sharan Nirmul, Esquire and Naumon Amjed, Esquire*

On June 26, 2008, the Second Circuit issued its long anticipated decision regarding the doctrine of “corporate scienter.” In *Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital Inc.*, No. 06-2902-cv (2d Cir. June 26, 2008) (“*Dynex II*”), the Second Circuit affirmed the doctrine of corporate scienter as a method for pleading claims against a corporate defendant under the federal securities laws. The “corporate scienter” doctrine allows an investor to hold a corporate defendant liable for statements made to the market that are rendered false and misleading because of fraudulent conduct of the corporate defendants’ employees, irrespective of whether those employees themselves made the statements or are named as defendants in the suit.

Dynex II marks a split among the federal appellate courts regarding the applicability of the corporate scienter doctrine. We see the decision as a positive development for investors seeking to hold corporate defendants accountable under the federal securities laws.

The District Court Requests Appellate Review of the Viability of “Corporate Scienter” within the Second Circuit

Dynex Capital Inc. (“Dynex” or the “Company”) is a financial services corporation principally engaged in the consummation of public offerings of debt securities using mortgages as collateral. See *In re Dynex Capital, Inc. Securities Litigation*, 2006 WL 314524, at *1 (S.D.N.Y. Feb. 10, 2006) (“*Dynex I*”). The plaintiffs, investors in Dynex stock, alleged that between 1996 and 1999, Merit (a subsidiary of Dynex) made thousands of loans to people seeking to buy manufactured homes. See *Dynex II*, slip op. at 4. In March and August of 1999, these loans were pooled and sold in two sets of asset backed securities. *Id.*

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SBTK WINS BACK-TO-BACK APPEALS UNDER THE SECURITIES ACT OF 1933

By: *Andrew L. Zivitz, Esquire*

In the fall of 2005, this newsletter informed its readers that the Federal Securities laws hold corporate wrongdoers responsible for negligent, as well as fraudulent, conduct. Roughly three years later, it bears repeating that fact as SBTK recently obtained two victories under the negligence-based Securities Act of 1933 (the “Securities Act”) before what most securities litigators consider to be the toughest court in the country — the Ninth Circuit Court of Appeals.

As SBTK has advised in the past, the Securities Act strictly prohibits companies from offering securities to the public pursuant to a materially false or misleading registration statement or prospectus. Notably, fraudulent conduct is not an element of a claim brought under the Securities Act. The reason: companies have a strict obligation to ensure the accuracy of their securities offering documents before accepting millions of dollars from unsuspecting investors. As a result of this strict liability regime, it is less difficult to state a negligence claim under the Securities Act than a fraud claim under the Securities Exchange Act of 1934 (the “Exchange Act”).

In 2005, SBTK filed separate complaints against Leadis Technology Inc. and Merix Corporation pursuant to the Securities Act for issuing materially misleading registration statements and prospectuses in conjunction with \$76.6 million and \$88 million stock offerings, respectively. Leadis, a creator of cellular telephone display drivers, sold its drivers to two principal customers in 2004 — Samsung and Phillips. SBTK alleged that Samsung was in the midst of dropping Leadis as a supplier at the time of the stock offering — a fact that Leadis was obligated, but failed, to disclose as it took \$76.6 million from unsuspecting investors. Leadis’ stock price dropped on poor sales results following the stock offering, thereby damaging investors.

Likewise, Merix, a creator of printed circuit boards for electronic equipment in 2004, claimed in its offering documents that Merix’s customer base was expanding and its employees strictly adhered to requisite quality control measures. Unbeknownst to investors, however,

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THE RIGHTS & RESPONSIBILITIES OF INSTITUTIONAL INVESTORS

Building on Institutions' Growing Interest in Active Engagement

March 12, 2009 • Renaissance Amsterdam Hotel • Amsterdam

Portrait by: Timothy Greenfield-Sanders



Keynote Speaker:

Madeleine K. Albright

Former U.S. Secretary of State (1997-2001)

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I would like to nominate a senior executive from my organization to receive an invitation to The Rights & Responsibilities of Institutional Investors.

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Note: Please do not secure your travel arrangements until you have received written confirmation from Institutional Investor of your registration. Participation is strictly limited to qualified investors. Due to capacity restraints, all registrations will be accepted on a first come first served basis. Institutional Investor reserves the right to make any amendments to the program.

BROCADE FEDERAL SECURITIES CLASS ACTION SETTLES FOR \$160,000,000

By: John Kehoe, Esquire

On June 2, 2008, Brocade Communications Systems Inc. announced that it had reached an agreement in principle to settle a federal securities class action lawsuit brought against the Company, its former CEO, Greg Reyes, former CFO, Antonio Canova, and several former directors, including well-known Silicon Valley attorney, Larry Sonsini. The class action, filed on behalf of those who purchased Brocade securities between May 18, 2000 and May 15, 2005, inclusive, alleged that the defendants had violated the federal securities laws by failing to disclose that stock option grants were routinely backdated to reflect more favorable exercise prices. The case, captioned *Brocade Securities Litigation*, Consolidated Case No. 3:05-CV-02042 (CRB), was filed in May 2005 in the U.S. District Court for the Northern District of California, San Francisco Division. The \$160 million settlement, the largest backdating settlement to date, is subject to final court approval. Formal notice of the settlement will be issued at a later date.

Schiffirin Barroway Topaz & Kessler, LLP represented Erie County Pennsylvania Employees Retirement System in the litigation, who served as the court-appointed co-class representative. Commenting on the favorable settlement, Sue Weber, Erie County's Controller, said "We are thrilled with the result that has been achieved." Gail Stone, executive director of court appointed lead plaintiff Arkansas Public Employees Retirement System (APERS), represented by Nix, Patterson and Roach, LLP (Nix), added "A recent study showed that most securities fraud class actions settle for less than 10 percent of investor losses. Our \$160 million settlement is the largest backdating settlement to date but, more importantly, it is close to a 100 percent recovery of the class's total damages."

The litigation stems from Brocade's massive restatement of certain financial results in prior periods from having manipulated stock option grant dates in order to boost the potential windfall for certain Brocade officers and other employees with lower stock option exercise prices that were selected with the benefit of hindsight in contravention of the Company's shareholder-approved employee stock option plan. As a consequence of the illicit practice, Brocade failed to record adequate compensation expenses and thereby artificially inflated its class period earnings.

Brocade was among the first companies to be engulfed in the stock option backdating scandals that rocked the public financial markets in 2005. Hundreds of public companies have since been investigated over improper stock options backdating. Notably, in a July 20, 2006 speech, SEC Chairman Christopher Cox addressed the widespread misconduct and admonished that "Options backdating strikes at the heart of investor confidence in our capital markets. It deceives investors and the market as a whole about the financial health of companies that cheat in this way. It understates a company's compensation expenses and overstates the company's income." Former SEC Chairman Arthur Levitt characterized stock option backdating as "ripping off shareholders in an unconscionable way" and that it "represents the ultimate in greed."

In addition to the civil litigation, the misconduct at Brocade has resulted in two criminal convictions. On August 7, 2007, after an eight-week trial, a federal jury convicted Mr. Reyes on four counts of securities fraud, four counts of lying to accountants, one count of conspiracy, and one count of false books and records. He was subsequently sentenced to serve 21 months in federal prison and ordered to pay a \$15 million fine. On December 5, 2007, after a two-week trial, a federal jury convicted Stephanie Jensen, the former human resources vice president at Brocade, on one count of conspiracy and one count of falsifying books and records relating to the scheme. She was later sentenced to serve four months in federal prison and ordered to pay a \$1.25 million fine stemming from her fraudulent backdating of stock options at Brocade.

When handing down the sentence against Mr. Reyes, United States District Court Judge Charles R. Breyer observed, "The integrity of the capital markets in this country is fundamentally grounded on the honesty of executives of public companies, and when they falsify a company's books and records and lie to auditors, regulators, and shareholders, there are real consequences to real victims, as there were here." Judge Breyer added, "The substantial prison sentence and fine should serve to deter similar corporate fraud in the future."

In May 2007, Brocade agreed to pay \$7 million to settle civil fraud allegations brought by the Securities and

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KOFI ANNAN INSPIRES DELEGATES AT THE THIRD ANNUAL RIGHTS & RESPONSIBILITIES OF INSTITUTIONAL INVESTORS SEMINAR *(Continued from page 1)*

The day began by conducting an electronic survey of the delegates' opinions on the very issues to be addressed in the seminar. The results were compiled, displayed and discussed as part of the day's ten presentations.

This unique introduction to the seminar's main themes not only gave Delegates a moment to reflect on their own opinions in advance of hearing what experts and academics had to say, but attendees were also able to benchmark their points of view against those of their peers across the globe.

Dr. Uew H. Schneider, a Professor at the Technical University of Darmstadt, followed with the presentation, "Institutional Investors Acting in Concert." Dr. Schneider outlined extant rules and regulations for delegates governing the concerted actions of shareholders, meticulously making the case for the power and efficacy of this approach to reigning in corporate malfeasance.

Participating for his third year in a row, Dr. Henrik Syse, a Senior Advisor for Corporate Governance at Norges Bank Investment Management, gave a presentation entitled "Taking the Next Step: Integrating Principles into Practice." Immediately following his lively and engaging presentation, Dr. Syse joined Dr. Daniel Summerfield of Universities Superannuation Scheme Ltd., Jeanett Bergan of KLP Asset Management, Deborah Gilshan of Railpen Investments, and Dr. F. C. Breen of Robeco, in discussing and debating specifically how shareholder activism can bring real and lasting change in the way corporations govern themselves, changes that ultimately benefit both shareholders and the larger global population.

SBTK partners Sean Handler and Stuart Berman each spoke on topics related to shareholder litigation discussing topics involving courts in the United States that affect investors from around the world. Mr. Handler gave an overview of the current judicial and regulatory climate surrounding both shareholder lawsuits and those standards of responsibility and accountability to which corporate officers are held. In particular, Mr. Handler described the rising interest among U.S. appellate courts, especially the U.S. Supreme Court, in issues such as loss causation, standing to bring claims, and third party liability. In addition, Mr. Handler gave an in-depth description of the Paulson Commission and the debate surrounding how independent its members are. Mr. Berman gave details on the Vivendi Universal class action pending in federal court in New York and

the predicament it has presented for many European investors. The presentation detailed how the court specifically excluded German and Austrian investors, as well as most other European investors by inference. Options to recover what may be significant losses were examined as were the reasons for the growing number of opt-outs.

"International Collective and Class Actions: A Review of the Landscape with Lessons for All" brought together legal and governance experts from across Europe, as well as Israel and Australia, to discuss collective actions in various jurisdictions. The session began with a presentation by Femke van't Groenewout of Dutch pension fund PGGM Investments explaining the solution they had devised to deal with class actions related to their investments. The panel, consisting of Jens Rostock-Jensen of Danish law firm Kromann Reumert, Elad Man of Israeli law firm Man-Barak Advocates and Solicitors, Bernard Murphy of Australia's leading class action law firm Maurice Blackburn Pty Limited, Paul Olden of Dutch law firm NautaDutilh NV, Ulf Djurberg of Swedish law firm Setterwalls Advokatbyrå, and Stefan Winheller of German law firm Winheller Attorneys at Law, discussed the value of recovering assets through collective and class actions and provided an overview of the collective and class actions that had been brought in various jurisdictions.

Recently retired founding partner of SBTK, Richard Schiffrin, led a panel of speakers that included Erick R. Holt who serves as general counsel of Allianz Global Investors AG, Mirza Baig, a corporate governance specialist at F & C Management, and Hank H. Kim who is general counsel at the U.S. based National Conference on Public Employee Retirement Systems to discuss "Shareholder Activism vs. Globalization." They discussed topics such as how engagement is changing in the global economy and how such engagement can shape and regulate the continued growth in international markets.

One of the major hot button issues for investors today was contemplated during a panel entitled "The Impact of Sovereign Wealth Funds on the Rights and Responsibilities of Other Shareholders." SBTK advisor Peter Kraneveld moderated panelists Martin Skancke from the Ministry of Finance of Norway; Gary King, the Attorney General of the State of New Mexico; and Aldo Lepori Cappelletti of Peruvian fund Oficina de Normalización Previsional – ONP, in debating how SWF's



size and influence are reshaping certain aspects of the financial markets and how that impacts other investors. They also discussed the backlash against certain funds in the Middle East and Asia and what should be done to bring those funds into the “mainstream.”

The final panel before the day’s keynote address was entitled “Actions Speak Louder than Words: Debating the UN Principles on Responsible Investment and Other Such Initiatives” and featured a distinguished panel of speakers from some of the largest institutional investors in the world. Moderator Anita Skipper, the Head of Corporate Governance at Morley Fund Management, was joined by panelists Jack Ehnes, the Chief Executive Officer of CalSTRS, Anna Hyske, a Senior Adviser at Ilmarinen Mutual Pension Insurance Company, Kris Douma, Head of Responsible Investment Support and Active Ownership at Mn Services, and Graham Sinclair from the Kenan-Flagler Business School at the University of North Carolina-Chapel Hill. This esteemed group discussed the various standards including the Aspen Principles, the ICGN Principles, and the UNPRI, how they are being implemented, and if they will achieve their goals.

This discussion specifically set the stage for Former Secretary-General Annan’s remarks. Mr. Annan offered his insights into some of the global issues uppermost on all of our minds including the environment, the war against terror, the growing issues with feeding people around the world and what investors and the corporate community can do to resolve these issues. Mr. Annan then engaged the delegates in a Q&A session that not only further delved into his comments, but brought new topics to the floor. It was clear that the audience was deeply engaged with Mr. Annan and appreciated hearing his views on many important issues.

The response to the seminar was again overwhelmingly positive and we are already planning and looking forward to next year. We will again be in Amsterdam and are moving back to the Renaissance Amsterdam Hotel, now that it has undergone a complete renovation. We are also very proud to announce that our keynote speaker will be Former U.S. Secretary of State Madeline Albright. We look forward to welcoming you in Amsterdam on March 12, 2009!

SBTK WINS BACK-TO-BACK APPEALS UNDER THE SECURITIES ACT OF 1933 *(Continued from page 3)*

Merix’s customer base was, in fact, contracting and Merix shipped out 15% of its PCBs in a defective state at the time of the stock offering. The Securities Act requires corporate stock issuers to include such material information in their offering documents. As with Leadis, Merix’s stock price fell on poor sales results following the offering.

As a result of these material omissions and misrepresentations, SBTK filed claims against Leadis and Merix on behalf of investors who purchased stock in the offerings. Defendants argued, and the lower courts in California and Oregon held, that the complaints “sounded in fraud” like claims brought under the Exchange Act, requiring the plaintiffs and SBTK to plead more detailed information than what was contained in the complaints. SBTK appealed both matters to the Ninth Circuit, arguing that the lower court erred because: (1) the complaints contained no allegations of fraud as they asserted only strict liability and negligence claims under the Securities Act; and (2) contained more than sufficient information to demonstrate that the offering documents were

materially misleading, thereby triggering liability under the Securities Act. The Ninth Circuit agreed with SBTK, holding that the complaints did not “sound in fraud” and that the lower courts’ decisions to the contrary must be reversed. Though Defendants in both actions sought *en banc* review by a larger panel of Ninth Circuit judges, the Ninth Circuit properly denied Defendants’ requests.

SBTK is extremely pleased with the outcomes. Indeed, obtaining back-to-back reversals is no small feat as the Ninth Circuit has historically reversed less than twenty percent of all appeals. Moreover, the decisions are a big win for investors who suffer losses in corporate stock offerings as they: (1) provide further assurance that damaged investors need not meet the heightened pleading burdens associated with fraud-based Exchange Act claims; and (2) counsel that investors need only plead that the stock offering documents were materially misleading or omitted to disclose a material fact to state a claim for liability under the Securities Act.



THE CURRENT STATE OF STOCK OPTION BACKDATING LITIGATION *(Continued from page 1)*

sitions by backdating stock options for their own self-benefit. State and federal agencies, including the U.S. Department of Justice, are increasingly prosecuting directors and officers for violations of the federal securities and other laws by falsifying corporate documents, deliberately backdating stock options, and lying to their shareholders about their misconduct. These developments have helped enable SBTk and its clients, who are appalled by the misconduct and greed of these corporate fiduciaries, to effectively seek to make those companies whole.

When the stock option backdating scandal broke in March 2006, derivative case law concerning the fiduciary obligations of directors in granting stock options was relatively undeveloped. However, throughout more than two years of stock option litigation, a body of case law has developed in courts throughout the country. This case law leaves little doubt that knowingly granting and receiving backdated stock options constitutes a blatant breach of fiduciary duty.

The seminal decision in this context remains *Ryan v. Gifford*,¹ in which Chancellor Chandler of the Delaware Chancery Court held, in a strongly-worded decision, that a director or officer who knowingly grants or receives backdated stock options, and lies about his conduct, violates his fiduciary duties, and such a decision is not protected by the business judgment rule. *Ryan* has been adopted by state and federal courts from coast to coast. By way of example, courts in cases such as *Conrad v. Blank*,² *In re Zoran Corporation Derivative Litigation*,³ *Edmonds v. Getty*,⁴ and *Belova v. Sharp*⁵ have adopted the Chancery Court's ruling in *Ryan*, determining that granting or receiving backdated stock options constitutes a breach of fiduciary duty. These and other similar cases have formed an important foundation upon which corporate fiduciaries who breach their duties to the companies that they serve may be prosecuted.

While *Ryan* and its progeny demonstrate that backdating stock options constitutes a breach of state law fiduciary duties, these and other cases also demonstrate that conduct in connection with backdating stock options is a serious violation of the federal securities laws. In *Zoran*, the Northern District of California concluded that two

former Zoran Corporation directors and officers not only breached their fiduciary duties to Zoran, but also violated Section 10(b) of the Securities Exchange Act of 1934 (the "Act") by knowingly filing false and misleading financial statements concerning Zoran's accounting treatment of backdated stock option grants. The *Zoran* court further concluded that these same executives violated Section 14(a) of the Act by knowingly disseminating proxy statements that falsely represented that stock options were properly granted, and by using these false and misleading proxy statements to secure reelection of the Zoran board of directors.

In a separate case concerning stock options backdating, Judge Charles R. Breyer of the Northern District of California denied defendant's motion for summary judgment in *Securities and Exchange Commission v. Reyes*,⁶ holding that Brocade Communications Systems, Inc.'s backdating-related financial restatement and the concurrent drop in Brocade's stock price indicated that there was a substantial likelihood that investors considered the false and misleading statements in Brocade's historical financial statements to be material. Mr. Reyes was convicted at trial of securities fraud in connection with his role in backdating at Brocade and has been sentenced to 21 months in federal prison. Brocade also recently agreed to settle a class action claim brought under the federal securities laws for \$160 million.

Meanwhile, the Securities and Exchange Commission and Department of Justice have continued to enforce civil and criminal actions against those fiduciaries who manipulate federal laws for their own self-benefit. Since July 2006, the SEC and DOJ have brought charges against approximately 30 current and former directors and officers of approximately 18 different companies for their roles in backdating billions of dollars of stock options. These charges involve companies big and small, prominent and lesser-known, and serve as a crystal clear reminder that stock options backdating is unlawful and harmful, and will not be condoned.

Most recently, the DOJ announced on June 5, 2008, that Broadcom Corporation's co-founder and former CEO, Henry Nicholas, and former CFO, William Ruehle, had been indicted in connection with Broadcom's massive stock options backdating scandal, which has caused Broadcom to restate its historical financial statements by approximately \$2.2 billion. Nicholas and Ruehle are alleged to have, among other things, deliberately backdated stock option grant dates, falsified internal corporate documents, and filed false and misleading financial statements with the SEC. The SEC also filed on May 14, 2008, a civil complaint

¹ 918 A.2d 341 (Del. Ch. 2007).


² 940 A.2d 28 (Del. Ch. 2007).

³ 511 F. Supp. 2d 986 (N.D. Cal. 2007).

⁴ 524 F. Supp. 2d 1267 (W.D. Wa. 2007).

⁵ 2008 U.S. Dist. LEXIS 19880 (N.D. Cal. Jun. 5, 2007)

⁶ 491 F. Supp. 2d 906 (N.D. Cal. 2007).



against Nicholas, Ruehle, co-founder and former Chairman, Henry Samuelli, and current General Counsel, David Dull, alleging that each of them knowingly violated U.S. securities laws in connection with the deliberate backdating of Broadcom stock options. Previously, the SEC and DOJ filed civil and criminal charges, respectively, against Broadcom's former vice president of human resources, Nancy Tullos. Ms. Tullos has settled the charges brought by the SEC in exchange for the disgorgement of \$1.3 million relating to backdated stock options and the payment of a \$100,000 civil penalty; Ms. Tullos has pled guilty to obstruction of justice charges and is currently awaiting sentencing. Broadcom itself has settled SEC charges in connection with stock options backdating by paying a \$12 million civil fine.

Broadcom, although perhaps unique in the size and scope of its backdating scandal, is a typical example of the egregious conduct that occurred in connection with stock options backdating. In addition to former Broadcom executives, the DOJ has brought criminal charges against former officers and directors of companies such as Brocade Communications Systems, Inc. (former CEO, George Reyes; former vice president, Stephanie Jensen), SafeNet, Inc. (former CFO, Carol Argo), McAfee, Inc. (former General Counsel, Kent Roberts), and Monster Worldwide, Inc. (former General Counsel, Myron Olesnyckyj). While many of the criminal actions in connection with stock options backdating remain pending, certain individuals such as Reyes (convicted of securities fraud at trial; sentenced to 21 months in prison and \$15 million fine), Argo (pleaded guilty to securities fraud; sentenced to 6 months in prison), and Comverse Technology, Inc.'s William F. Sorin and David Krienberg (pleaded guilty to securities fraud charges) have faced the harsh reality of their improper, unlawful, and self-serving conduct.

In addition to charges brought by the DOJ, the SEC has charged numerous companies, executives, and directors with civil charges in connection with stock options backdating and violations of U.S. securities laws. To date, the SEC has brought charges against, among others: Brooks Automation, Inc., and its former chairman and CEO Robert J. Therrien; Marvell Technology Group, and its co-founder Weili Dai; Lisa Berry, who is alleged to have backdated stock options General Counsel of both KLA-Tencor Corporation and Juniper Networks, Inc.; Apple Inc.'s former CFO, Fred Anderson, and former General Counsel, Nancy Heinen; McAfee's former General Counsel, Kent Roberts; and Monster's former General Counsel, Myron Olesnyckyj. Certain companies and executives have settled the charges brought against them by the SEC for the pay-

ment of civil fines and other remedies, the most prominent of which remains the settlement of charges brought against UnitedHealth Group, Inc.'s former Chairman and CEO, William McGuire, who settled the charges brought against him for \$468 million in fines and penalties, to date the largest civil settlement involving stock options backdating.

The influence of the SEC and DOJ in prosecuting corporate fiduciaries for their unlawful conduct in connection with stock options backdating has undoubtedly been an important component in the effort to punish corporate wrongdoers. The federal government's pursuit of certain high profile directors and officers has, however, placed upon public shareholders an increased importance in seeking recoveries on behalf of companies against those executives and directors who have manipulated their positions in order to financially benefit themselves. These public shareholders have risen to this challenge, securing, and continuing to secure, substantial benefits for companies through stock options backdating litigation.

Settlements of shareholder derivative litigation involving stock options backdating generally include two components, the weight of which varies with each settlement: financial contributions and corporate governance enhancements. Financial contributions found in the settlement of stock options backdating litigation generally come in the form of the repricing of backdated stock options, cancellation of backdated stock options, and/or disgorgement of proceeds from the sale of backdated stock options. For example, SBTK served as lead counsel for plaintiffs in litigation pending on behalf of Barnes & Noble, Inc., the settlement of which resulted in the payment of approximately \$5 million to the company, including \$2 million in cash payments by executive officers. Similarly, the settlement of derivative litigation on behalf of Cablevision Systems Corporation resulted in certain officers and directors paying the company aggregate consideration valued at approximately \$24.4 million, Sepracor, Inc. resulted in certain officers and directors agreeing to cancel or reprice more than 2.7 million unexercised stock options that were alleged to have been improperly granted, Monster resulted in company founder Andrew McKelvey paying the company \$8 million in cash, and Family Dollar Stores, Inc. resulted in the cancellation of hundreds of thousands of stock options granted to certain current and former officers, resulting in a seven-figure net financial benefit for the company.

In addition to providing substantial monetary value to companies, settlements of backdating litigation have pro-

(Continued on page 12)



SECOND CIRCUIT AFFIRMS “CORPORATE SCIENTER” DOCTRINE *(Continued from page 3)*

Income from the underlying loans acted as collateral for the securities. *Id.* According to the plaintiffs, in 1999, the underlying loans began defaulting. *Id.* Concurrently with the increasing default rates, the amount Merit was recovering from the sale of foreclosed homes was declining. *Id.* at 4-5. In April 2004, Merit disclosed that it had identified “an internal control deficiency” related to the recording of loan losses, and would therefore restate its earnings for two periods in 2003. *Id.* at 5. As a result, the price of the asset backed securities collapsed by 85%. *Id.* The Dynex plaintiffs alleged that the Company, in order to increase its market share, adopted an undisclosed policy of buying very risky loans, and these risks were concealed from investors. *Id.* at 6. The complaint named Dynex and Merit (both corporate entities), as well as two of Dynex and Merit’s officers as defendants. The defendants moved to dismiss all claims in *Dynex I*. The district court dismissed claims against the individual officer defendants (for failing to plead scienter) but held that scienter was adequately pled as to Dynex and Merit. *Id.* at 7. As explained by the Second Circuit:

The district court noted plaintiff’s allegation that “Dynex systematically originated defective loans, despite clear signs that borrowers were not creditworthy.” In its view, these allegations allowed the inference that “officers and employees of the corporate defendants had the motive and opportunity to commit fraud.”

Id. at 7. Reorganizing a split among the district courts, Judge Baer certified *Dynex I* for appellate review in June 2006. See *In re Dynex Capital, Inc. Securities Litigation*, 2006 WL 1517580, at *3 (S.D.N.Y. June 2, 2006).

Second Circuit Affirms “Corporate Scienter”

Almost two years after *Dynex I* was certified for appeal, the Second Circuit issued its opinion. In *Dynex II*, the court held:

When the defendant is a corporate entity, this means that the pleaded facts must create a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter. In most cases, the most straightforward way

to raise such an inference for a corporate defendant will be to plead it for an individual defendant. ***But it is possible to raise the required inference with regard to a corporate defendant without doing so with regard to a specific individual defendant.***

Dynex II, slip op. at 12. (emphasis added). The Second Circuit then analyzed the facts pled in *Dynex* and held that plaintiffs failed to plead that **any** employees of Dynex or Merit acted with scienter. The court remanded the case to the district and permitted the plaintiffs to replead their claims.

Although *Dynex II* establishes the general contours of the “corporate scienter” doctrine — “[plaintiff must plead facts creating] a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter” — the decision does not establish who within a corporation could impute knowledge to the corporate entity for purposes of liability under the securities laws. We believe that traditional principles of agency law will likely govern this question. The *Dynex* decision accords with the Seventh Circuit’s decision in *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 708 (7th Cir. 2008) which acknowledges that it is possible to draw a strong inference of corporate scienter without being able to identify any corporate individual with knowledge of the falsity of the Company’s statements.

We note, however, that *Dynex* splits from the decisions of the Fifth and Ninth Circuits. See *In re Apple Computer, Inc.*, 127 Fed. Appx. 296, 303 (9th Cir. 2005) (rejecting the corporate scienter doctrine and holding that a plaintiff was required to adequately plead scienter against a named officer or director defendant of a company in order for the company to be liable under the securities laws); *Southland Securities Corp. v. INSpire Insurance Solutions, Inc.*, 365 F.3d 353, 366 (5th Cir. 2004) (same).

We believe that *Dynex II* is a positive development for investors seeking to hold corporations liable for the fraudulent conduct of their employees where such conduct results in investors being defrauded.



CALENDAR OF UPCOMING EVENTS

Pension Funds & Class Actions: What You Need to Know

September 10, 2008

London, England

This conference, which is specifically designed for fund Trustees, will focus on education on topics ranging from U.S. and European collective actions, filing claims, and active participation. Legal and pension experts from the U.S. and Europe will present on these issues and more.

Council of Institutional Investors 2008 Fall Meeting

October 5–7, 2008

Hilton Chicago — Chicago, Illinois

International Foundation 54th Annual Employee Benefits Conference

November 16–19, 2008

Henry B. Gonzalez Convention Center — San Antonio, Texas

This conference is designed to meet the specific needs of multiemployer and public sector plan trustees and administrators, attorneys, accountants, actuaries, investment managers and others who provide services or who are involved in the overall management and administration of benefit trust funds.

2008 International Corporate Governance Network Mid-Year Conference

December 9–10, 2008

Hotel du Pont — Wilmington, Delaware

- This conference will look at the new reform agendas in corporate governance, global shocks and opportunities. Topics will include:
- View from the bench: Meet the Delaware judiciary
 - What's new in the White House: Impact of the elections on corporate governance
 - Shareholder litigation
 - Hot button issues: Shareholder access, advisory votes on pay and more

NCPERS Public Safety Employees Pension & Benefits Conference

October 12–15, 2008

Palm Springs, California

NCPERS Annual Legislative Conference

February 2–4, 2009

Hyatt Regency Hotel — Washington, D.C.

Council of Institutional Investors 2009 Spring Meeting

April 5–7, 2009

Mandarin Oriental Hotel — Washington, D.C.



THE CURRENT STATE OF STOCK OPTION BACKDATING LITIGATION *(Continued from page 9)*

vided companies with substantial improvements to their corporate governance policies, not only guarding against the reoccurrence of stock options backdating, but also providing for the lawful, efficient, and successful operation of these companies in the future. By way of example, the settlement of derivative litigation on behalf of Emcore Corporation resulted in a multitude of corporate governance enhancements including, but not limited to: the company committing to grant stock options with an exercise price equal to the fair market value of the company's common stock on the date of grant; a commitment that the company will not reprice stock options, nor exchange them for options with a lower exercise price; the adoption of an improved insider trading plan; the adoption of enhanced independence standards for board members; and the adoption of director tenure limitations. HCC Insurance Holdings, Inc. has also settled litigation pending on its behalf in the United States District Court for the Southern District of Texas. In connection with this settlement, HCC has agreed to develop a revised equity incentive plan to be

voted upon by its shareholders, adopt enhanced director independence standards, and ensure that the chairman of its board of directors shall not simultaneously serve as the company's CEO. Unquestionably, these and other similar settlements have provided companies with immediate and long-lasting substantial benefits.

Stock option backdating litigation pushes on into its third year with the clear message that backdating is unlawful, harmful to companies, and will not be tolerated by public shareholders or the federal government. Positive developments in case law and efforts by the federal government to prosecute those who abused their responsibilities by enriching themselves have enabled public shareholders to successfully demand that the harm caused to companies through stock options backdating be remedied. SBTK is pleased with its accomplishments thus far, and is committed to continuing to pursue its efforts to not only recover for companies the damages caused by stock options backdating, but improve upon the manner in which companies are operated in the future.

BROCADE FEDERAL SECURITIES CLASS ACTION SETTLES FOR \$160,000,000 *(Continued from page 5)*

Exchange Commission. Brocade also attempted to settle a related federal derivative action, but Schiffrin Barroway Topaz & Kessler, LLP appeared in that action on behalf of the Puerto Rico Government Employees Retirement System (PRGES), and together with APERS and Nix, objected to a proposed derivative settlement on the ground that it provided no benefit to shareholders and resulted from an improper conflict of interest because the proposed derivative action settlement would have released claims Brocade had against Mr. Sonsini and Brocade's

outside law firm, Wilson Sonsini Goodrich & Rosati, PC (WSGR), yet WSGR had been representing Brocade in the derivative action and had negotiated the proposed settlement. In ruling upon PRGES's objection, Judge Breyer expressed concern over WSGR's potential conflict of interest. Soon thereafter WSGR withdrew from representing Brocade in both the derivative action and the securities class action, and counsel to plaintiffs in the federal derivative action withdrew the proposed settlement. The derivative action is still pending.



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